

Jan Evers · Stefanie Jack · Adriaan Loeff · Hedwig Siewertsen



# REDUCING COST AND MANAGING RISK IN LENDING TO MICRO ENTERPRISES

Handbook for Micro-Lending in Europe



produced by FACET, Zeist, The Netherlands and

IFF – Institut für Finanzdienstleistungen e.V., Hamburg, Germany

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## To whom it may concern: How to use this handbook

We wrote this handbook for practioners in micro-lending – either running a micro credit scheme or planning one.

The handbook consists of six separate subjects which can be worked through individually. At the end you will find a summary of the points we found most important.

### Chapters of the handbook

- institutional setting of the micro credit institution
- attracting clients
- services offered
- appraisal or "pre-credit" phase
- monitoring or "post-credit" phase
- default management

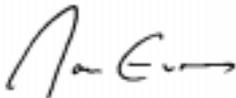
We would suggest using the book either by rating the chapter subjects according to what is most important for your organisation. You could for example set up a **task force „Improvement“** to check one handbook chapter every month for the elements worth discussing for potential implementation into your organisation – these selected issues could then be presented to the team and discussed. Even if you decide not to change very much, it could possibly widen your awareness of potentials for improvement or potentials for problems.

To make the book as useful as possible, we have highlighted good and bad experience with symbols:



We hope that the book means that all micro-lenders don't have to make the same mistakes or unhappy experiences when giving **credit**, the latin word for **TRUST**. However, life experience demonstrates that exchange of experience is not an easy task to achieve.

Good luck

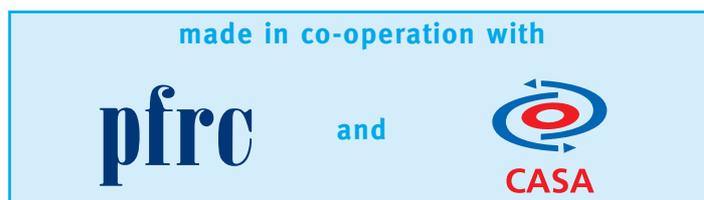


from the research team

*More information on the research project can be found on the internet under <http://www.iff-hamburg.de/> with the quick start keyword „micro-lending“.*

We are very grateful to the following persons and organisations for their support and willingness to share knowledge during this research:

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The research project **”Benchmarking in micro-lending; Working towards best practices”** is led by the Institute for Financial services (IFF) in Hamburg and co-financed by the DG XXIII of the European Commission. The other project partners are:

- Personal Finance Research Center (PFRC) in Bristol, UK
- CASA, Copenhagen, Denmark
- FACET, Zeist, The Netherlands

The last partner was responsible for the draft of this handbook.

The objective of the overall research project is to identify successful micro-lending experiences in Europe and the USA, in order to support new micro credit initiatives undertaken by credit providers both within and outside the traditional banking sector.

Micro entrepreneurs, defined as those who need a credit between 1,000 and 25,000 EURO, are often considered as a risky client group for banks, because they lack collateral or the capacity to convince banks that they are able to get and repay a business loan. Micro entrepreneurs usually have no track record and lack financial reporting that the formal sector requires. The costs of processing small loans and the risks involved in lending to micro businesses, make financial institutions hesitant to develop services for micro entrepreneurs. All these factors inhibit the **access to credit** for micro entrepreneurs.

Micro-lending in this study has the following distinguishing characteristics compared to mainstream banking:

- non traditional creditworthiness assessment criteria
- non traditional collateral accepted
- loan officers are not necessarily bankers
- credit is provided along with business support services
- credit amounts are between 1,000 and 25,000 EURO

These differences make micro-lending a successful instrument in promoting the establishment of small and single person enterprises. The potential clients do typically not have access to mainstream credit provision because they lack steady employment or a solid credit history as security and are considered as risky clients. The loan amount needed is often small, and therefore the transaction costs are high.

In short, the most significant problem for lenders, is the combination of high risks and high costs of micro-lending. However, international experience has shown that the ”uncreditworthy” are able to repay loans and to become, through self employment, independent from governmental income support. These people include for example redundant employees, young graduates, immigrants or single mothers. In addition, some of the microentrepreneurs prove to have the high potential banks are looking for. Micro-lending is the technique to identify them.

The research project should formulate answers to the following questions:

1. What is the most efficient way to undertake the creditworthiness assessment?
2. How can lending take place if traditional securities are absent?
3. How can entrepreneurs be efficiently supported, in order to lower the failure rate of start-ups?
4. How can potential clients be attracted in an efficient way?

This handbook aims to contribute to a better understanding of the different aspects of financing micro enterprises. Through the presentation of various possibilities of reducing the costs and risks of micro enterprise financing, the handbook will hopefully convince more organisations to develop lending activities for micro enterprises.

The study started with the preparation of four country reports on micro-lending. These country reports have been prepared in Germany, The Netherlands, Denmark and the United Kingdom and give an overview of current practices and experiences in the four countries. From these country reports it was learned that in all the four countries there was a gap in the offer of financial services, in particularly for the following groups of entrepreneurs:

1. **those with home based industries**
2. **those who start step by step**
3. **those in need of small loans**

Full details on the results of the country reports can be found on the research project homepage under [www.iff-hamburg.de](http://www.iff-hamburg.de) with the keyword or the button "micro-lending".

For the benchmarking part of the research, the research team looked into a wide range of micro-lending organisations to decide who may be best suited for a further investigation. Under the organisations we scanned were:

**Tor#10**, Warsaw – Poland

**Kvinnebanken Norgesnett**, Norway

**The Prince's Youth Business Trust**, London – UK

**The Aston Reinvestment Trust**, Birmingham – UK

**King Baudouin Foundation**, Belgium

**The Self Help Project**, Network Credit to refugees and immigrants, Oslo – Norway

**Central Brooklyn Federal Credit Union**, USA

**ALMI**, Sweden

**WEETU** (Full Circle – Women's Employment, Enterprise and Training Unit), Norwich – UK

**Sustainable Strength**, Birmingham – UK

**MamaCash**, Amsterdam – Netherlands

**BancoSol**, Bolivia

**Starthilfefonds**, Bremen – Germany

**Göbi Fonds**, Göttingen – Germany

**North London Credit Union**, UK

**EBRD**, Russia Small Business Fund

**Greater London Enterprise**, UK

For a range of reasons they were seen as less appropriate for the limited benchmarking capacities in this research project than others: loan size on average too large, organisation just started, hard to get reliable information, too similar to an organisation already visited, sustainability not an organisational objective etc.

The institutions finally selected and analysed for this study are:

1. **ACCION**, New York, United States of America
2. Association pour le Droit à l'Initiative Économique (**ADIE**), Paris, France
3. **Fundusz Mikro**, Warsaw, Poland
4. Glasgow Regeneration Fund (**GRF**), Glasgow, United Kingdom
5. Industrial Common Ownership Finance (**ICOF**), Birmingham, United Kingdom
6. Women's World Banking (**WWB**), Spain
7. **Working Capital**, Boston, United States of America
8. **FINNVERA**, Finland (well known as Kera but recently renamed after a merger)

The selected organisations are characterised by the fact that they have implemented innovative methodologies and products, in order to deliver services to groups of micro entrepreneurs which were not serviced by the traditional institutions like banks or financing companies. In general, they were seen as advanced of most micro-lenders in one important part of the lending process and therefore a good subject for the micro-lending community to learn from.

Each of the organisations was visited for two days by two members of the research team. During that visit it was aimed to fully understand the process of lending of the organisation by working through all printed information, becoming introduced to the information system including client database and financial controlling, speaking to loan officers and visiting clients. In addition, the financial situation of the organisation should be understood to see the financial impact of the chosen lending strategy.

As a documentation of each visit an extensive "**case study**" on each organisation was drawn consisting out of three chapters: Chapter one is a description of the history and working method of the organisation including the most important facts on outreach and sustainability. You find this part included in the annex of this handbook. Chapter two is a selection of what we found remarkable good ideas in the practical lending process. The best of these ideas you find in this handbook in the "**best solution**" sections. Finally, chapter three of each case study is a selection of areas for potential improvement. This was seen as a service and a thank you to the organisation for participating in the benchmarking project. Therefore the chapter is kept confidential to the public. However, a range of things the research team learned here are documented in the "**pitfalls to avoid**" sections in this book.

After completing the case studies a draft of this handbook was written. In a **seminar for micro-lending practitioners** and micro-lending start ups in May 1999 in Hamburg, the topics of this handbook were discussed with representatives of eleven micro-lending organisations from Europe and the US and results tested against their experience. More than thirty of the key experiences/ results of this seminar have been implemented in the handbook afterwards.



With this very positive seminar experience in mind, the research group hopes to establish a network of new and existing micro-lending initiatives both within and outside the traditional banking sector. We intend to overwork this handbook regularly with the experience and comments of our readers.

### 3.1 Lending to micro enterprises vs. traditional lending

As an introduction to the subject some key differences in the service delivery principles of micro versus "traditional" lending are presented. Micro-lending is characterised by its small loan size, the non-traditional aspects of collateral requirements and assessment of credit worthiness, and the quick and easy access. The higher transaction costs of micro-lending are covered either through above market level interest rates or subsidies.

#### 1. Lending practices

Traditional banking	Financial services for micro enterprises
Collateral needed	Peer pressure or alternative collateral accepted
Appraisal based on business plan and financial records (cash-flow, experience.)	Appraisal takes into account other criteria like motivation, recommendation by social network
Repayment enforced by legal action (collateral, guarantee)	Positive enforcement of repayment (stepped or sequential loans, peer pressure)
Asset-based lending	Cash-flow based lending
Difficult procedures lead to high transaction costs for small loans	Special techniques to reduce administrative costs

#### 2. Institutional Setting

Traditional banking	Financial services for micro enterprises
Formal financial institutions ruled by the central bank act	Different legal statuses are possible: e.g. foundation, trust, limited company, NGO
Staff are professional bankers	Staff often have a non-banking background
Centralisation of decision-making (often hierarchic organisation)	Decentralisation of decision-making (subsidiary principle)

#### 3. Promotional policies

Traditional banking	Financial services for micro enterprises
Banks wait for clients to ask for credit, clients are approached in a formal way and have to defend their credit requests in front of bank staff	The need for credit is systematically identified, contacts are more informal, group meetings are used to exchange experiences and gain self-confidence.
Clients are self-confident enough to visit the bank and know how to present themselves	Clients do not have the confidence to approach a bank
Promotion of banking services in general is done through the media and word of mouth: in small enterprise lending most banks do not actively promote their services.	Clients recruit new clients (self selection) and partner networks (enterprise agencies, social workers) refer potential clients

### 3.2 Sustainability and impact

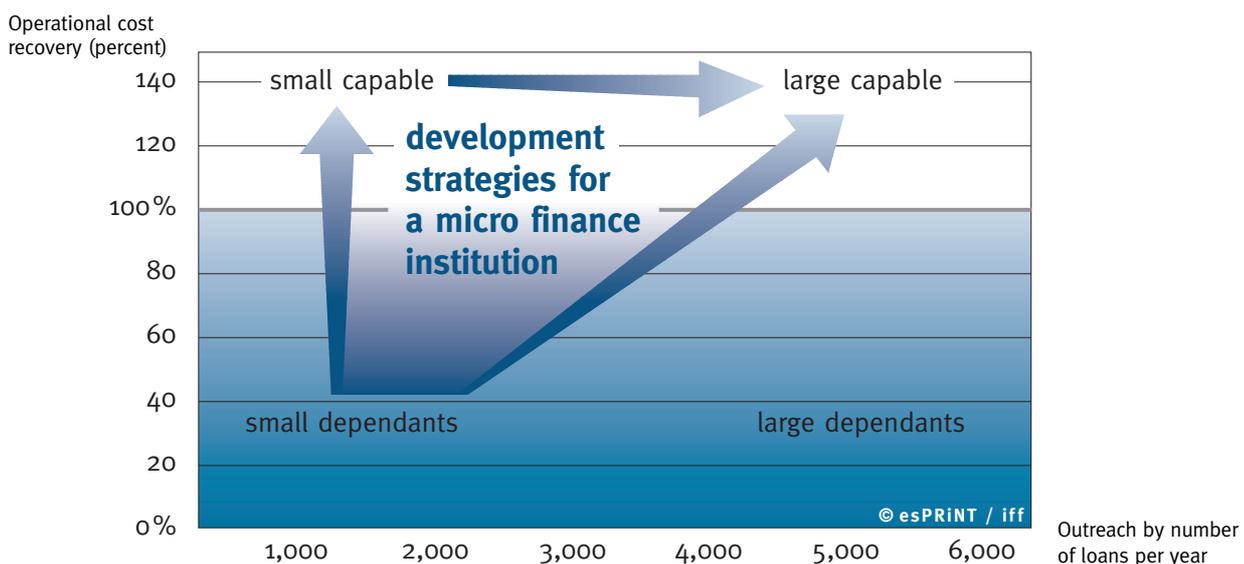
This handbook is about cost reduction and risk management. These two issues are a prerequisite in sustainable micro-lending practices and traditional banking. The presentation of successful methods and practices to those involved in finance and enterprise promotion will, hopefully, convince many more people that lending to micro enterprises can be sustainable. A financially self-sufficient credit institution must cover its operating expenses, loan losses and the cost of funds with the income earned from charging fees and interest. Here the issue of **Efficiency** is at stake. Are these operations run in the least expensive manner?

#### Sustainability in this handbook is defined at four different levels

(developed by Otero and Rhyne, 1994):

1. **Highly subsidised programmes:** grants and soft loans cover operating expenses and establish the revolving loan fund. The fund erodes due to loan losses and inflation, there is a permanent need for subsidies and grants.
2. **Fully revolving fund:** interest income earned covers the cost of funds and some operating expenses. Grants are required to finance some operational expenses.
3. **Operational sustainability:** Income covers cost of funds and operational expenses. However, some element of subsidy remains due to the financial costs of maintaining the value of a revolving loan fund in a highly inflationary environment, or of paying commercial rates of refinancing costs.
4. **Financial sustainability:** All costs are covered with the interest and fees charged by the organisation and funds are raised at commercial rates from formal financial institutions (or profits are high enough to do so in theory).

#### The Sustainability Performance Box:



The sustainability performance box provides an analytical framework for evaluating the performance of a micro-finance program based on outreach and operational cost recovery. Programs that do not cover 100 percent of their operational costs will remain dependent on donations or government subsidies to maintain their current activity level. A drop in subsidies would automatically deplete loan capital and result in a reduction in

the number of borrowers using the program. Institutions that cover more than 100 percent of their operational costs do not depend on donors for their operational costs, but do require funds for lending. Institutions that cover their operational and financial costs are fully sustainable. Sustainability requires a minimum level of outreach. In order to reduce the costs of lending, the institution needs a certain number of clients to reap economies of scale (Brandsma and Chaouali).

Most of the benchmarked organisations have chosen different development paths. For example:

- ADIE started small but developed a nation-wide branch network very quickly. Due to the regulatory environment and their chosen objectives the organisation remained dependent on public subsidy but has reduced the amount of subsidy per loan over time.
- ICOF developed a nation-wide service but without a branch network and, while staying small, it became independent of public subsidy.
- Fundusz Mikro started nation-wide and quickly developed a branch network to achieve maximum outreach, economies of scale and the fastest track to sustainability.

### Cost reduction can take place in different categories:

1. **operational expenses** – important aspects of methods to reduce operational costs are:
  - the reduction of transaction costs through the externalisation of costs
  - economies of scale and standardisation
  - efficient procedures and loan administration, decentralisation of decision-making
  - differentiating costs of non-financial and financial services
  - linking loan officers' payment to performance
2. **loan loss** – important aspects of methods to reduce default:
  - pre-credit screening, character and analysis of cash-flow instead of assets and documents
  - post-credit monitoring, using information technology to track borrowers' and manage loan portfolios
  - collateral requirement, acceptance of new types of guarantees (e.g. group guarantee)
3. **cost of funds** – important aspects of methods to reducing the costs of funds are:
  - capacity to attract long-term low-cost funds
  - capacity to negotiate loan terms with lending institutions
  - opportunities to attract savings

### IMPACT ISSUES

Regarding the impact of micro-lending, the important aspect is the long-term availability of loans for micro-enterprises at an affordable price. This means that the institutions providing the loans should be strong, sustainable organisations which have a long-term growth strategy in order to secure the future. Therefore this handbook is focused on sustainable micro-lending practices. Impact criteria in the benchmarking studies included an assessment of outreach, accessibility of loans for the target groups and impact on the local community, such as the facilitation of economic activity and self-employment.

### 3.3 Further reading on micro finance theories

During the last decade the issue of micro-finance has received a lot of attention. Many books and articles have been written on financial services for micro enterprises. Most publications deal with experience and approaches in "the South, or the developing countries. This handbook focusses only on micro credit in Europe and American. Therefore, it can "plough back" experience gained in industrialised countries into the practices used in the "South".

Some reference books are listed here in order to provide some general, theoretical background reading.

1. **Micro Start... a Guide for Planning**, Starting and Managing a Microfinance Programme, United Nations Development Program. An excellent guide book on how to start and manage a sustainable micro-lending institution. Attention is paid to the business plan, procedures, and financial aspects of a ML organisation. However it might, in some areas, not be fully relevant for the European context.
2. **The New world of micro enterprise finance**, Building healthy financial institutions for the poor, edited by Maria Otero and Elizabeth Rhyne, 1994. This book introduces a new direction for micro enterprise finance. The editors and contributors argue that one can create sustainable and viable financial institutions that give marginal groups greater access to financial services. Topics covered include: the financial systems approach; savings mobilisation; principles of regulation and prudential supervision; process of institutional development and the evolution of non governmental organisations; credit unions; the solidarity group experience; the village bank methodology.
3. **CARE Savings and Credit Sourcebook**, Waterfield C. and Duval A., Overview of different methodologies used in micro-lending and saving. Design of appropriate instruments taking into account the various types of enterprises and their different needs. The source book includes an overview of intervention levels, delivery channels and lending methodologies. The issues of impact, sustainability and efficiency are very well explained and analysed, 1996.
4. **Maximising the outreach of Micro enterprise Finance**. The emerging lessons of successful programmes, Robert Peck Christen et al.: 1994
5. **Tomorrow holds another future**, Salient points and Lessons learned form IGA promotion and support programmes carried out by the Netherlands co-financing agencies", FACET BV, DGIS, 1998. This document compiles world-wide experiences on IGA and SME promoting projects including a financial component. The salient points and lessons learned in financing programmes include: Innovations that reduce transaction costs, Diversity of financial services, Local resource mobilisation, Needs assessment for financial and non financial services, Interest rates, Flexible collateral, Simple and quick procedures, Professionalism, Outreach and Accountability.

## Different institutional settings in relation to organisation's mission

### 4.1 Introduction to the institutional settings of micro finance institutions

#### Variety of institutional forms

Micro finance institutions come in a variety of institutional forms including NGO's, non-banking micro finance institutions or micro-finance units within commercial banks.

The institutional setting of (financial) services organisations for micro-enterprises is defined by its role, activities and funding.

If the organisation is a **pure financial institution**, which does not receive long term subsidies or grants, the operational costs should be fully covered with the margins made on lending operations and fees charged from clients. This type of financial institutions can therefore only cater for the better clients among the "non bankable" people. The legal status of such an organisation will be defined by a Central Bank Act or similar legal settings enabling the institution to handle credit and savings.

On the opposite side, an organisation aiming to reach "the poorest of the poor", in consequence, needs to **provide extensive business support to clients** and is unable to finance itself without public subsidy. It is likely that in exchange for long term subsidies or grants its client focus (regional, group, gender, ethnic minority etc.) will be defined by the donor. The legal status of such an organisation can be, for example, an NGO, foundation or public institution with a clearly defined mission and target group which corresponds with the donor's objectives.

For both types of organisation the **objectives sought** (for example degree of sustainability or outreach to the socially excluded), **activities undertaken** (whether lending is the main operation), the **targeted client groups** (which types of non-bankable clients) and **funding of operations** (cost covering or subsidised) will of course be very different. Successful examples of micro-lending organisations originate from all types of institutional settings.

## 4.2 Different aspects of the institutional setting

### Outreach

Some institutions aim for country wide coverage of their services, others attribute their strength to the fact that they work locally and are well aware of the situation and needs of micro entrepreneurs.

### Growth strategy

The issue of outreach and growth strategy very much depend on the development stage of the micro-lending institution. Broadly speaking there are three stages:

1. **Development stage**, in this stage the methodology is developed, implemented and modified. If signs of impact are achieved, long term strategies for the next stage can be developed
2. **Sustainability stage**, in this stage consolidation and cost effective implementation of successful methodologies are central issues. Working towards financial self sufficiency in preparation for expansion of activities will be important
3. **Expansion stage**, in this stage the organisation makes structural transformations in order to scale up its operations to reach a greater number of people.

This framework is not valid for all types of enterprise support organisations. Some want to stay small and operate locally (GRF) because their funding is based on local authority funds. Other organisations do not aim for self sufficiency (ADIE, WWB) because they have an orientation towards more excluded client groups and are prepared to continuously depend on some external subsidies and grants.

### Client focus and source of funding

An institution aiming to deliver services to "poor" clients using grants and donated funds is not necessarily seeking self sufficiency in the sense of trying to cover operational costs with the margin made on lending operations. **The chosen institutional setting of the organisation defines to what extent self sufficiency will be reached or aimed for.** !

A **company** (like ICOF or Fundusz Mikro) should always try to increase profit in order to satisfy the stakeholders, even if it means that "poor" clients will be excluded from the services delivered by the company. On the other hand, a **foundation or association** is obliged to realise its stated objectives even if this means that the organisation depends on subsidies and grants.

### "the best clients among the non bankable" versus: "the poorest of the poor"

The different organisations, therefore, target different client groups in the "non-bankable" category. Organisations like Fundusz Mikro, Accion and Finnvera which are aiming at a high degree of financial sustainability, try to reach the best clients among the non-bankable. In practice this means that they rarely finance start ups of marginalised groups of society and they minimise the support services for the borrowers. ADIE and WORKING CAPITAL, in contrast, receive grants and subsidies to exclusively focus on start-ups and socially excluded client groups and to provide business support services.

### Write off target rate in relation to customer focus

#### Different customer groups have different failure probabilities (risk).

This should be held in mind for market segmentation. The Princes Business Trust (PBT) was advised to set a write off target for its organisation of between 25-40% because they wanted to target a risky and very excluded/not-bankable market. The UK initiative RSN/STREET set a target of less than 5% because they wanted to concentrate on the best of the excluded/not-bankable clients.

### Relation with banks

Most of the micro-lending initiatives aim to be **complementary to the existing banking system**. The client groups can therefore be distinguished between bankable and non-bankable. If a good relationship can be established between banks and micro-lenders the two organisations can **refer clients** to each other. The credit histories built up at the micro-lending institution could be valid to convince banks of the creditworthiness of a person. Banks could refer to the micro-lending institution people to whom they cannot lend due to lack of collateral or experience in business. This exchange of information and clients is one of the important goals of networks of financiers. In some of the benchmarked organisations the relationship between banks and micro-lenders is developing.

### Exchange of information and clients

## Comparison with micro finance experiences in developing countries

Many successful micro finance experiences are drawn from developing countries (BancoSol Bolivia, BRI Unit Desa Indonesia, K-rep Kenya). Even though there are many similarities between those experiences and the benchmarked organisations in this study, on the basis of institutional setting there are at least two major differences:

1. the density of "traditional" banks in Europe and the USA is much higher
2. legal action against defaulters is easier to undertake in Europe and the USA due to credit and property registration and a dense network of court houses and legal institutions

These two factors make it easier for micro-lending institutions to save on costs for financial transactions. Most **cash handling** (disbursements, collection of repayments) can be handled and administered by a "traditional" bank. Secondly the **risk exposure** of defaulting borrowers is reduced due to legal measures which are available in Europe and the USA.

On the other hand, the spread or margin that can be realised in Europe and the USA, is under a lot of pressure, and is generally very small. This has already put pressure on the intermediary role of the regular banking sector. The fact that ML institutions offer credit to otherwise excluded clients results from the fact that micro-entrepreneurs are prepared to pay a higher interest rate compared to what commercial banks would charge. However, their willingness to do so is limited. In developing countries, the net interest margins are generally much higher, allowing for more "slack" in operational efficiency.

### 4.3 Traditional pitfalls in institutional orientation

**Mixing of financial and non financial services delivery**

Financial services delivery should aim to be a viable operation with a long term strategy for growth and cost recovery. Assistance activities to micro-enterprises often have a social orientation and the costs are not fully covered by fees. Grants and subsidies are part of the funding strategy of such organisations.

**Seperate financial service and assistance activities**

From a sustainability point of view it is very important to separate the two different activities and related funding. Often the two functions of credit delivery and assistance, like the funding for them, are mixed. In order to build up sustainable, viable financing institutions for micro enterprises it is important to stress the institutional separation of the different functions.

In accordance with the above it is very important that subsidies are not used to cover the losses from badly designed or managed credit schemes. Credit delivery in itself should be aiming for self sufficiency and should not need subsidies. In contrast, support activities could rely on subsidy.

**Restriction of services due to legal environment**

Non-banking institutions are often not allowed to collect savings from the public. This means that some credit institutions lack opportunities to obtain cheap funds for lending and are limited in the services they can offer their clients. In some countries, even credit delivery is limited to formal banking institutions. The example of WWB in Spain which limits its services to enterprise support activities and leaves all the financial services to co-operating banks is illustrative.

**Staff is 100% banker or 100% social worker**

Most micro-lending requires staff that combine the capacities of both bankers and social workers. Creating a **company culture** that strikes a balance between the two extremes to suit the needs of both the clients and the institution is often a major challenge for the management.

**What business are we in?**

Another danger is mixing social intentions with business needs in lending. To make this clear, we ask the following question to micro-lenders:

**What business are you in? Financial Services or Social Services?**

and answer by quoting Martin Hockley of ICOF:

*"Our social orientation is reflected by the choice of our clients. Once they become a borrower, we treat them as business like as any bank would do."*

**No linking between micro-lending institutions and banks**

The absence of a referral system between banks and micro-lending institutions can lead to a mismatch between funds and target groups. A bankable person who is not referred to a bank, and remains a client of the (subsidised) micro-lending institution means that there is a mismatch of institution and client, and support services that are meant for unbankable people are used by the wrong client group. On the other hand, do micro-lending institution miss out unbankable clients who are refused by the bank but not referred to the micro-lending institution? Being part of a financial services network is therefore important for banks and micro-lending institutions.



## 4.4 Best solutions: Methods and institutional structures in benchmarked organisations

### ISSUE: LEGAL BARRIERS TO BECOME A MICRO BANKER

 **WWB Spain:**  
private foundation linking micro entrepreneurs and banks

As banks are the only institutions which are allowed to provide credit in Spain, WWB has made agreements with five banks to deliver financial services to WWB clients.

WWB assists women micro entrepreneurs in writing their business plans, and helps them to gain self confidence. From all clients referred to the banks by WWB, 95% are successful in obtaining a loan. The extensive support given to the women overcomes barriers which traditionally exist for (female) micro entrepreneurs. However, the hard and costly job – the pre-selection and support – is done by WWB, but generates no income from either clients or banks.

### ISSUE: STATE INTERVENTION TO SUPPORT THE WEAKEST, IN A TRADITIONAL SETTING

 **FINNVERA:**  
state owned financial institution aimed at new firms and SME's

An interesting example of mixing banking and social sector features is FINNVERA. The organisation applies banking procedures and administrative systems, but thanks (or due) to state intervention and subsidised interest rates FINNVERA can finance groups that are not bankable: weaker groups in the business society instead of the most profitable sectors. Its mission is to focus on correcting deficiencies and upgrading the efficiency of financial markets by removing the obstacles SME's will have in access to finance due to the lack of collateral. Since 1996, FINNVERA has run a loan scheme targeted on micro enterprises and micro start ups.

### ISSUE: DO NOT MIX BUSINESS SUPPORT WITH FINANCIAL SERVICES

 **ACCION**  
New York: providing credit to existing micro entrepreneurs

ACCION decided to specialise in financial services for micro enterprises. One of the interviewees stated: *"You are either good in giving support services or in financing services – most organisations try both and fail in both"*.

Another interesting point about ACCION is to assist clients in approaching the bank. Typical clients do not want to go to the bank because of bad experiences in the past. By assisting the clients who qualified for a loan in going to bank to collect the money from there, they increase clients' self confidence ("they walk clients to the bank").

### ISSUE: LINKING SOCIAL SUPPORT ACTIVITIES TO TRADITIONAL BANKING

 **ADIE: an association assisting excluded individuals in starting up businesses and finding loans**

ADIE sees itself as a social organisation not aiming for self sufficiency. Therefore the organisation accepts grants and subsidies in order to provide services to not-bankable people. A clear administration is maintained where transparency in the cost structure is realised. Each working hour is recorded against categories like "lending activity" or "client support".

Clients who qualify for a second loan are referred to a co-operating bank, where they can get non-subsidised loans. ADIE has an agreement with 25 banks in France, 75% of the ADIE clients receive credits from one of these banks.


**ISSUE: SELECT THE BEST FROM BANKING AND MICRO-LENDING**


**Fundusz Mikro: limited liability company owned by a not-for-profit incorporated organisation**

In 1999, FM is the only micro-lender in Europe with a sustainable lending activity. It lends to existing micro-enterprises with a 3 month positive cash flow. FM's lending methodology is the result of research into international best practice.

In FM there is an interesting combination of professional banking features and more 'assistance-oriented' characteristics. The typical bank features in FM are:

- the organisational structure, consisting of a front and a back office and separate credit management
- the financial management systems which are based on bank experiences (e.g the credit risk assessment is done in line with some Citibank procedures)

The typical non-bank features of FM are that:

- FM is not registered as a bank under the supervision of the Central Bank. This institutional setting enables FM to apply lending practices which are not traditional but as a consequence FM is not allowed to collect savings.
- Banking experience is considered to be a disadvantage rather than an advantage for the FM staff. The credit methodology used by FM requires staff with know-how in enterprise development and business management.

**ISSUE: FLEXIBILITY IN INSTITUTIONAL STRUCTURES TO SERVE DIFFERENT FUND PROVIDERS**


**ICOF: many legal entities (inc., fund plc., guarantee fund, ltd. company) providing loans and mobilising (and managing) funds**

ICOF has been very successful in reducing costs of funding. ICOF attracts funds from the public for micro-lending activities. Through the many different institutional settings of the various ICOF connected institutions, they have reached several funding partners. One organisation specialises in tapping public local economic development funds, another organisation is member based and issues shares to the members. The third organisation specialises in attracting grants and charity funding from the general public. The whole institutional setting enables ICOF to offer interesting tax conditions to the donors and provide cheap money for ICOF's operations.

**ISSUE: MIXTURE OF BUSINESS SUPPORT AND FINANCIAL SERVICES**


**Working Capital: incorporated company, franchising its training packages and methodology and providing loan capital to affiliates or "hubs"**

This organisation provides both, financial and non financial services to marginal micro-enterprises. Only 12% of the income is generated by the loan operations and fees. WC is a service oriented organisation largely dependent on grants and subsidies to cover their costs due to their client focus. However, it is important that within the organisation the cost structure is clear by differentiating cost of and income from support and financial services. Presently WC is working on this issue. There are two outstanding aspects of WC's work: The issuing of franchises and support strategies provided through manuals which are used within peer groups.

**ISSUE: NETWORKING BETWEEN BANKS AND AN INDEPENDENT, LOCALLY ORIENTED FUND**


**Glasgow Regeneration Fund: Fund targeting small business development**

The co-operation with the formal financial sector is a very interesting feature of GRF. First of all, the Royal Bank of Scotland supported GRF with a grant and, secondly, the bank provided secondees to work with the GRF staff in loan administration and collection. The exchange of views between a socially oriented and a commercially oriented financial services provider is a very enriching experience for the staff members involved.

### The first contact

## 5.1 Client profile and mission of organisation

The first contact between a client and the service institution is very important. On the one hand, the organisation needs new clients which could benefit from the services provided. On the other hand, it needs to be able to select good customers as early as possible for cost efficiency reasons.

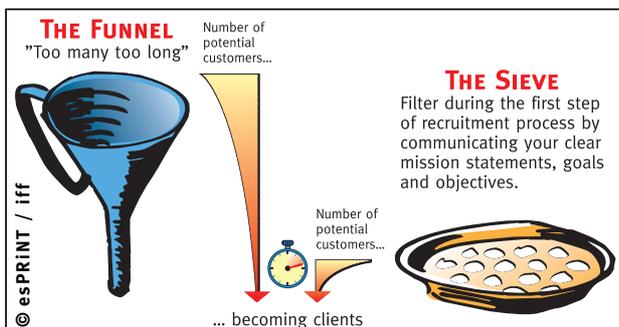
From the organisation's business plan it should be clear which clients are targeted with the services. The next step is to define a strategy to promote the services to the potential clients. This means identifying the key message and the medium to be used. There is a big difference between saying: **"If you have a problem starting your business come to us"** and saying **"Successful entrepreneurs borrow from us"**. The choice of media and referral agents also plays an important role in reaching the right clientele.

## 5.2 Attracting clients in a cost effective manner

**There are various steps in the process of attracting new clients:**

- Make known to the public that the organisation exists and present its activities
- Identify the information providers for the targeted clients
- Provide information via selected media on what clients can expect from the organisation
- People contact the organisation and discover whether they can benefit from the services
- Use the networks of your new clients to recruit more clients

### Early selection



This graph illustrates the importance of early selection: The classic funnel-method represents the practice of narrowing down a large number of potential customers to finally becoming clients by many consecutive meetings ("too many too long"). In the right model a thorough early "sieving" is done in the very first period of contact. The earlier the pre-selection is done, the cheaper the process of attracting clients becomes.

### Mission of organisation

The organisation should clearly define its mission, because the expectations raised by the clients should be realisable. *Does the institution want clients to come and ask for a loan, or does it want the clients to ask for assistance in writing a business plan?* Cost reduction means that the **major filtering** of clients occurs **in the first step of the recruitment process**. That can be achieved by communicating clear mission statements, goals and objectives. **!**

### Media and referral agents

Most organisations attract new clients through "word of mouth" promotion and information flyers. If an organisation is able to direct most of its inputs (human resources, promotional expenditures, etc.) towards people who, in the end become a (paying) client of the organisation, then they have achieved cost effective promotion. Active acquisition can prevent organisations investing time and money in people who are ultimately not interested in getting a loan or paying for a training.

**Investing in referral agents** who will attract the right clients to the organisation can prove to be cost effective. These "agents" should be well informed on the objectives and target group of the micro-lending organisation. Time should be invested to familiarise the "agents" with the organisation in order to assure effective referral. To create a learning referral system means informing the agents about how useful their referrals were. **!**

### 5.3 Traditional pitfalls in market positioning and selection of clients

#### Expensive media awareness

- All organisations have experienced the problem of media awareness leading to many calls for information. Providing all people with the necessary information involves a lot of expenses which are often not justified by an increase in loan portfolio. One example is an organisation where only 9 out of 100 people who call for information are selected as appropriate for a loan.

#### Unsuccessful networking

- Another experience is that social workers and public support agencies mostly refer the clients they, themselves, do not want to deal with anymore: poor people with financial problems instead of business ideas.
- On the other hand, one UK micro-lender found that its external client acquisition network operated in its own interests. In particular, enterprise agencies refer only what they regard as "good" customers. For example, they focused on start-up rather than existing enterprises and it was difficult to make them understand that the micro-lender required the exact opposite. So without strong communication external filtering may lead to the wrong result.
- It is often difficult to get the banks to refer clients to non-banking financial institutions. It takes time to build a relationship in which the two institutions acknowledge that they are complementary in their services.
- In addition, it is necessary to convince potential referral agencies, like the chamber of commerce or the banks, that disadvantaged people can be good entrepreneurs and borrowers, and to show them what type of people to look for.

**! So good networking is a challenge but remember it is worth it: it can dramatically reduce client acquisition costs.**

#### Force competition

Competition among micro-lending institutions is apparent in the USA. It is becoming more and more difficult to recruit micro-entrepreneurs for credit programmes because of the increased number of employed people who qualify for consumer loans and credit card facilities from banks. On the other hand, an increase in the number of institutions providing micro-loans to excluded groups has also been observed.



Instead of competing with other flexible financial services providers, WORKING CAPITAL and ACCION sought co-operation with a telephone bank to reinforce each others' strengths. The telephone bank accepts less than 10% of credit applications due to a rigorous scoring system. It refers the best of the "uncreditworthy" to the micro-lender.

#### Image of a loan shark

Many micro-lenders fight with the image of being "another loan shark". Many potential clients have experienced or heard of the inappropriate loan products and brutal collection methods of money-lenders and sworn never to use them (again). Micro-lenders have to overcome this and should aim for a marketing strategy that directly attacks this image. One idea could be to present a partner with a responsible public image – for example government agencies or banks.

While the above problem is typical for countries with an intensive money-lending network (UK, USA), a different but still comparable problem exists in countries where the concept of lending is not popular. Fundusz Mikro found that in the Polish business environment their lending methodology was often seen as "not open to

the public/not accessible” or ”not fully legal”. As a consequence, Fundusz Mikro uses adverts in journals to demonstrate that they are accessible, legal and as reliable as a bank.

#### Inappropriate services for grown up clients

There is a conflict whereby good clients who are ready to enter the formal financial sector (where credit is often cheaper) are also the most profitable clients for the micro-lending organisation. Are clients expected to graduate or to remain clients of the same organisation? If you give the clients no opportunity to leave the organisation, the service offered will become inappropriate and the risk of default increases. This phenomenon has been observed in one organisation which has a very high concentration of default in clients with larger loans and a longer credit record.

#### Risk concentration in groups

In the self-selection process for group-lending it seems that less committed clients look for other less committed clients which undermines the credibility of the group. It is difficult to establish mixed, risk-diversifying groups (i.e. not all involved in the same type of business) because people tend to select their own kind.

#### Too much attention?

New organisation often receive a lot of media attention which attracts many potential clients. This may lead to a work overload for the loan officers and less care given to screening and the long-term strategy regarding client acquisition.

## 5.4 Selected successful methods in client attraction, derived from the benchmarked organisations

#### Working Capital: Enterprise alliance

##### ISSUE: CLIENTS ATTRACTED THROUGH EXISTING NETWORKS

This organisation regularly (twice a month) calls public information meetings. These meetings are hosted by churches, community development organisations or other institutions that work with WORKING CAPITAL's target group. Most of the group formation takes place during these meetings, but as people are often not very familiar with each other, WORKING CAPITAL opted for a new method: "the enterprise alliance".

Existing professional member-based organisations are identified, with a view to offering group-loans which are formed within the existing organisation. The experience so far with farmers and artisans alliances are encouraging. Because the risk is considered lower within the enterprise alliance groups, the interest rates on loans are lower (10.9%) than the loans for members of peer groups (12%)

#### Fundusz Mikro: self selection of groups

##### ISSUE: FINANCIALLY INTERESTING TO ENTER AS A GROUP

Clients form their own groups, a strategy which often leads to groups where existing family or business relations are the basis. As the group members have a joint and individual liability for all the loans, the process of self-selection will lead to greater credit worthiness. The linkages between the group members are depicted in a clear schematic diagram so that the relationships and interconnections are transparent (see diagram in the case study in annex 6). The group loans have a lower interest rate, which reflect the lower promotion costs to be made by FM. Part of the cost reduction in client acquisition is refunded to the clients.



**+** ACCION: award for bringing in new clients

**ISSUE: CLIENTS ATTRACT NEW CLIENTS, LOW COSTS FOR EFFECTIVE WORD TO MOUTH**

ACCION reinforced word-of-mouth acquisition through a reward system for bringing in new clients. Each client referring a new client who qualifies for a loan receives US\$50 as a reward. Making use of existing clients who know the organisation and are therefore able to refer potential new clients is a cost reducing promotion strategy. However, this promotion scheme is offered only to the best clients on the basis that good clients will find good clients.

**+** FINNVERA: linked to well known state business service centres and banks in Finland

**ISSUE: EFFECTIVE SEPARATION OF MARKETS**

FINNVERA is a very well known institution in Finland as it has 15 regional offices close to the customers and in close co-operation with other institutions for entrepreneurs, for example enterprise agencies and business service centres. In addition, it recruits many clients through the traditional banking sector. As the two organisations are not allowed to compete with each other (by state regulation), their markets are clearly defined. If the credit request concerns a micro-enterprise, the clients are referred to the FINNVERA desk and clients graduating from FINNVERA are sent to the bank.

**+** WWB Spain: recruitment in market promotion events where a concentration of potential clients can be found

**ISSUE: TARGETED MARKET PROMOTION**

The main sources of new clients are

1. Annual trade fairs organised by WWB, where craftsmen can sell their produce.
2. Three co-operative shops where entrepreneurs can sell their products for commission. As marketing is often a major problem for micro entrepreneurs these two "test locations for market opportunities" provide an excellent insight into the chances of profitability for the enterprises. If the products seem to interest the public WWB can start assisting the entrepreneurs in their preparation of a loan request.

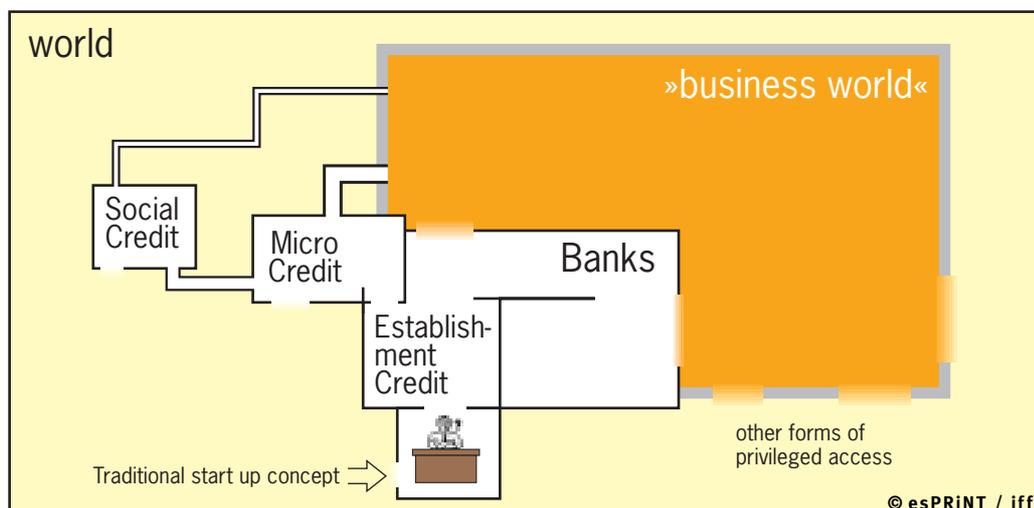
**+** Princes Business Trust (PBT): targets "criminals"

**ISSUE: TARGET NICHE MARKETS**

Research generally (not just in the UK) shows that about a third of young men, aged under 30, have at some time been 'apprehended by the police'. With this on their records it can be very difficult for them to find a regular job. However, PBT have encountered a great deal of entrepreneurial activity within this group, although they have little access to a start up credit. Therefore, PBT targets this market niche.

**»The House of Credit«**

and its corridors into the business world



## Services offered by ML organisations to micro-entrepreneurs

### 6.1 Introduction to financial and non-financial services

Services for micro-entrepreneurs often include new products which are different from traditional loans or enterprise support services. Some organisations provide both **financial and non financial services**, others are specialised (see chapter 1).

#### Different types of clients need different approaches towards support services

Another distinction which should be made is whether the organisation focuses on **new entrepreneurs or on existing businesses**. Both types of entrepreneurs would need different approaches towards support services.

A third distinction for the financial services providers is the **group-lending vs. individual lending**. In group-lending the objective is to hand over pre-credit and post-credit activities to the group in order to save costs. Another possible reason for the group-lending strategy is that group members guarantee each other, and are individually liable for the repayments of each other's debts. This diminishes the need for traditional collateral like houses or physical assets. Furthermore, the internal support within the group also diminishes the default rate. However, group-lending proves only appropriate for some types of clients as explained below.

### 6.2 Different aspects of the services offered by micro-lending organisations

#### Financial and/or non-financial services

Experience gives some evidence that organisations should focus on either business support services or on financial services. The risk of "getting stuck in the middle" and not being able to provide either of them on a sustainable basis is realistic. Business support services will always depend on external funding (grants, fees, subsidies) whereas financial services can be provided in a self-sufficient way. The separation of responsibilities, income and costs is very important in institutions that provide both types of services.

The below steps follow the **development stages of entrepreneurs**. The challenge is to match the needs of the entrepreneurs at each stage with the available credit products. *(on the left side we show this by using the picture of "The House of Credit")*

	Social credit	Micro credit	Establishment credit
typical clients	<ul style="list-style-type: none"> <li>• trying to find a way into work</li> <li>• no or very limited experience</li> </ul>	<ul style="list-style-type: none"> <li>• in or beyond start up phase</li> <li>• some business experience or business plan</li> <li>• too small, new and risky to be bankable</li> <li>• businesses with modest aspirations for growth</li> </ul>	<ul style="list-style-type: none"> <li>• nearly bankable</li> <li>• want to develop from micro to small firm</li> </ul>
Services offered	<ul style="list-style-type: none"> <li>• grants and subsidised loans</li> <li>• a high level of support and mentoring</li> </ul>	<ul style="list-style-type: none"> <li>• small stepped loans</li> <li>• on the job advice on financial management</li> </ul>	<ul style="list-style-type: none"> <li>• loan packages</li> <li>• co-operation with specialised support agency</li> </ul>
organisational examples	ADIE, PBT, Working Capital	ACCION, Fundusz Mikro, Finnvera Micro Loans	ART, Finnvera small firm loans, ICOF

## Services offered by ML organisations to micro-entrepreneurs

Some examples of **different types of micro loans**:

- **Repeated loans / stepping loans:** This type of loan is very popular in micro-lending organisations. Every time a borrower repays his/her loan in time, he/she qualifies automatically for a bigger loan. This loan type encourages prompt repayment, and is in this sense cost and risk reducing
- **short vs. long term loans:** Most organisations provide short to medium term loans. The choice of term depends on the terms of the available funds and whether the clients want to finance working capital or investments with their loans
- **individual vs. group loans:** individual loans can be tailor made but incur high transaction costs, group-loans are cheaper to provide for the lending institution (reduced costs and risk of default), but the formation of groups and the inflexibility of the group loan system are major drawbacks of the system. However there are different group methodologies:

### Example:

*In Fundusz Mikro and Accion the role of the group members is to co-sign each other's loan agreement for joint liability. In Working Capital the group's role is extended to mutual development and support among group members. Here the group decides in autonomy about creditworthiness.*

### Role of the group in lending

### Pricing of services

The organisation should determine its prices (interest, fees etc.) with a view to **becoming self sufficient** (if that is an aim) or at least recovering the costs of its lending activity. Financial planning and liquidity forecasts are important instruments to determine the costs of services. The effect of grants and subsidies is that loss-making institutions continue to exist. This could, of course, be deliberate, for instance if the subsidising party attaches high value to the existence of the organisation, regardless of the costs involved. In any case, **Transparency** in which funds, fees or interests are used to cover which expenditures or losses is very important.

The pricing of services (basically expressed in interest rates and fees) has two aspects.

1. The internal (cost price) aspect, and the external (market positioning) aspect. This is of course a normal issue with all institutions selling products or services.
2. The choice of whether cost coverage or competitive and affordable credit delivery is more important depends on the overall mission or objectives of the organisation.

### 6.3 Traditional pitfalls in selection of services to offer

Few organisations manage to be self-sustainable and if they do, it is through a reduced scale of services. Generally speaking only the institutions that deliver financial services are in a position to become self sufficient. If support services are provided (business advice, training, .), it has to be clear how the costs of these services will be covered.

#### Not matching the client

The dilemma "Do we: a) develop products for identified clients or b) find clients for identified products" is a question to be resolved on a **strategic level**. Matching the client and the product is often difficult if the target group is not clearly identified and if no proper market research has been conducted. Too many different products make the administration of the organisation complicated and expensive.

**The determination of the interest rate** is often subject to a lot of discussion. Subsidise interest rates are still the general practice, although experience has proved that credit subsidies do not contribute to the well being of poorer people. It is much more important to make financial services accessible for poor disadvantaged people, than lowering the interest rates. Artificially low interest rates diminish the self sufficiency of the credit institution and as a consequence, lower the credit-rating of the institution.

#### Client does not accept support/advice

Many organisations offer ongoing support to clients to reduce the lending risk. However, quite frequently they find that the entrepreneur feels s/he does not need it. Even when they encounter business problems they do not accept advice.

One **way** to overcome this problem is to:



identify the element of the interest rate charged that relates to the level of risk and offer mandatory insurance for the loan (i.e. twice as high as the average risk rate) and reduce the fee if clients actively take part in the support program.

#### Most expensive product the lowest price

An example of pricing which does not accord with the market law, is the organisation whereby the most expensive credit product, i.e. micro loans, has the lowest price due to interest subsidies. The commercially more interesting loans for SME's are double the price of the micro loans. This looks politically correct but the business case is poor and clients are misled.

#### Incoherent mission and service

A crucial pitfall exists where the mission and services offered are contradictory. This is the case where the objective of the organisation is to support the socially excluded, or new micro enterprise while at the same time, the conditions to obtain credit or other financial services are so strict that the target group can never qualify for them.



### 6.4 Successful product and service combinations derived from the benchmarked projects

#### ISSUE: ALLIANCES WITH NON-FINANCIAL BUSINESS SUPPORT AGENCIES



#### FINNVERA: Differentiation in the market through state regulation

In Finland the products and services which can be provided by Finnvera are to some degree defined by the state. The non-financial services are provided by another public institution, the business service centres, and the commercially interesting loans are provided by the banks. The state has the ability to regulate the market because Finnvera benefits from interest subsidies which are not allowed to disrupt the "normal market". Finnvera clients benefit from two free consultations at the business support centre.

#### ISSUE: FOCUS ON ONE TYPE OF SERVICES



#### ACCION: purely financial institution

ACCION New York only offers financial services to its clients and it wants this activity to become financially self-sufficient. Business advice is not provided which reduces the operational costs of ACCION.

All loans are stepped loans out of which 50% are group loans and 50% individual loans. All loans have the same interest rate, the service fees however are a bit higher for individual loans as they are more expensive to administer.

Presently ACCION is investigating whether it can offer insurance products together with a mainstream financial institution.

#### ISSUE: BECOME A NICHE PLAYER FOR A VERY SPECIFIC TARGET GROUP



#### WWB Spain: designs innovative products and convinces bankers to implement them

WWB has no lending activities, it assists customers in making their loan application to the banks. Secondly, WWB designs credit schemes for its target group, which it then tries to have implemented by traditional banks. WWB does part of banks work, which makes it more attractive for banks to deal with (female) micro entrepreneurs. Instead of asking money for this service, WWB demands better conditions for its clients.

WWB negotiated with several banks to offer credit to WWB clients with advantages compared to traditional financial products from the bank. The loan term is longer, the interest lower and a grace period of 2 years is possible. In addition to these loans, WWB offers the following products:

- Urgent Credit scheme through Banco Popular Espagnol for emergency loans at high interest rates.
- Credit Solidaire, which consists of a group-lending scheme where collateral requirements are very low.
- VISA credit cards through Banco Populaire, WWB receives 0,5% commission on the turnover made with the cards.
- Loans to bridge the gap between when clients qualify for a grant from public authorities and when they get the money (usually 1 year).



### ISSUE: MARKET ORIENTED PRICING FOR DIFFERENT PRODUCTS

- Fundusz Mikro: price differentiation and product specialisation**
- FM offers two different credit products: individual loans and group loans at market prices. The interest for members of a group is 29% per year, against 37% for individuals (January 1999). Group loans are cheaper because the costs are lower:
- the self selection of the group members saves promotion costs of FM
  - one session is enough to explain the FM procedures to 4 (borrowing) group members instead of giving four individual briefings
  - by screening the four members, four interest earning loans can be disbursed according to the screening of one borrower and his/her three guarantors which lead to only one interest earning loan disbursement

This cost structure and the fact that FM does not provide additional non-financial services makes the organisation cost effective: sustainability has been reached within four years.

### ISSUE: MARKET PRICING

- ICOF: flexible fees for borrowers**
- ICOF applies a flexible fee, depending on the effort spent on loan appraisal and processing. Besides interest payment the borrowers have to pay membership fees or become investors. Loan losses are covered with the waived dividends which are invested in ICOF guarantee company. This fund provides loan loss coverage.

### ISSUE: EFFICIENT NON-FINANCIAL SUPPORT SYSTEMS

- Working Capital: standardised and centrally produced support kits**
- Working Capital has developed standard handbooks for business advisory services and training. New affiliates can use this already developed material, which reduces the costs of the advisory services. Staff of various independent "hubs" are centrally trained and benefit from already developed training material and software packages.

### ISSUE: BUREAUCRACY

- ADIE: volunteers against bureaucracy**
- Many clients of ADIE struggle with the bureaucratic requests of entrepreneurs in France. This is worsened if they have language problems. To tackle that ADIE uses volunteers which fit into the middle class perception of public authorities and asks them to give support to entrepreneurs who are struggling to fulfil their demands.

### ISSUE: CLIENT SUPPORT IN MARKETING

- PBT: grants for marketing**
- To enable and motivate clients to do a structured marketing policy, The Princes' Business Trust, UK gives small grants for market research.

## 7.1 Introduction

Once a potential client is attracted to the programme, the organisation should assess, at the lowest possible costs, whether the person or enterprise is creditworthy. This process of "pre credit" analysis includes appraisal of the client's business, credibility, capacity to repay, entrepreneurial capabilities, market situation and financial analysis. All this information needs to be gathered at the lowest possible costs in order to diminish the risk of disbursing credit to the wrong person.

### Asset or cash flow based lending approach

In this respect one can distinguish the so-called "asset based" lending approach, and the cash flow based approach. In the first case, the appraisal of the client's credit worthiness is limited to the assessment of the assets (collateral) that the client can pledge against the loan. In the second case, the basis of appraisal is the assessment of the cash flow that the investment will generate, in which case the appraisal is much more oriented to the business potential and the capabilities of the client as an entrepreneur. Asset based lending is more the classical personal loan type of credit.

Micro credit operations are more oriented on the cash flow based approach, since the client often does not possess sufficient assets as collateral.

## 7.2 Cost effective client screening: different aspects

### Minimalistic vs. Individual client screening

The two extremes of creditworthiness assessment are the minimalistic approach and intensive individual screening of business and personal characteristics.

In the minimalistic approach, the credit institution does not care very much to what end the credit will be used. The screening consists of very standardised steps to be followed, which lead to disbursement of a standardised credit. (e.g. if you save 100 during 3 successive months, you get a credit of 500).

The individual approach towards credit screening aims to assess on a case by case basis the profitability of the investments and the capacity of the borrower to repay the loan. This process is only cost effective if the loan amounts to a certain level, where interest income can cover the appraisal costs.

### Traditional vs. Innovative screening methods

Bank screening methods are often **asset based** as where micro-lending organisation look for different assessment criteria **based on character** of the borrower. The bank's information is derived from a balance sheet or yearly accounts of the enterprise. The indicators used are often the financial ratios and asset taxation figures. Micro-lenders have developed other indicators for client screening. Innovative sources of information can be telephone calls to the landlord or electricity company to check the regularity in payment of the potential borrower, whereas site visits can provide an insight into the quality and efficiency of work in the enterprise.

In general, **standardisation of appraisal procedures** and tools will assist more efficient appraisal. The balance must be found between standardisation, and the direct personal contact and interpretation of the client by the credit officer.

**Co-signing**

Many micro-lending models use a co-signing methodology. The potential client is asked to bring one or more co-signers – people who take over (a limited) responsibility to repay the loan if the client defaults. The main advantage, apart from the additional security for the lender, is a pre-selection process. In general, only borrowers who are perceived to be likely to succeed will be able to find co-signers. Therefore the lender benefits from informal knowledge about the borrower's reliability from within his community – a much easier way to gain information than formal interviews, appraisals etc. Co-signing is a form of managing risk through a **filtering network**.

**Co-signing policies**

However, the experience of most micro-lenders suggest the following:

- It is important to assess the financial situation of the co-signer to prevent domino effects. For that reason it makes sense to motivate the co-signers to ask for loans themselves because the assessing work is done already. FM is doing this by reducing the interest rate for lending in groups then with co-signers.
- Models which rely on co-signing only work if amount is limited or loan amount is small. For large loans the responsibility of the co-signor becomes too big with adverse affects on who accepts that risk. To be able to benefit from the filtering network described above the loan amount co-signers guarantee can be limited.
- Family members seem to be inappropriate as co-signers – their decision to sign is based more on loyalty than on economical criteria. Finnvera has stopped using family/friends as co-signers. FM only uses family members very rarely, preferring fellow entrepreneurs through their group loans.

## Performance Overview

	Staff/Affiliates as of 01.99	Disbursed loans 1998	Delinquency rate 1998	Sustainability rate 1998
Fundusz Mikro, *1994	64/33	10.700	2,3%	operational break even!
FINNVERA, *1999 *71 as Kera, *96 micro loan program	400/15	3711 (micro loans)	9%	n. a. (80% for all loans)
ICOF, *1973	3/0	32 <sup>①</sup>	3,8%	50% <sup>②</sup>
ACCION *1961 worldwide, *1991 USA	7 (N.Y.)	217 (N.Y.) 888 (total U.S.)	13,2% (N.Y.)	45% (N.Y.) 13 – 58% (U.S.)
ADIE, *1988	80/14	1629 <sup>④</sup>	6% <sup>④</sup>	20 – 30%
Working Capital, *1990	10/4	270	14%	20%
Glasgow Regeneration Fund *1993	4	46 (04.98 – 03.99)	n. a.	0%
Women's World Banking *1989	23/1	21 <sup>③</sup>	0%	0%

<sup>①</sup> – from own resources; 90 loans in total counting funds in management and backoffice service    <sup>②</sup> – based on income through lending activity

<sup>③</sup> – all packaged for bank partners    <sup>④</sup> – including packaged loans for bank partners

### 7.3 Traditional pitfalls in client appraisal

#### — Social orientation in appraisal of clients

The credit appraisal should be directed at the profitability of the enterprise which is going to be financed. Whether someone is poor or excluded should not play a role in the individual credit appraisal – apart from the general decision to lend to a specific, probably discriminated market.

#### — Too costly screening methodology

The traditional screening methodology is cost effective if the loan amounts to a certain minimum. Below that amount it is too expensive to for example draft a business plan, visit the enterprise or analyse financial reports.

#### Example:

*One organisation does a first contact interview which takes at least two hours with any person interested in the organisation. This method is of course very time intensive and therefore costly. If a more intense selection is done before the two-hour interview the personnel costs can decrease dramatically.*

#### — Appraisal is too paper oriented

If a borrower is not able to write a business plan or to provide evidence of collateral, it does not mean that he or she is not able to manage a loan or an enterprise. Traditional banking often requires a lot of documents which are a major drawback for micro entrepreneurs. In some countries, the government subsidises the writing of a business plan with external help. This has a number of disadvantages. First, it means that banks incur additional costs of reading this business plan but it also has averse effects: for example, some micro-lenders have found that there seems to be a positive correlation between perfect looking business plans and later failures indicating reliance on external help (*"the better the business plan, the worse is the client"*).

#### — Loan officers values

Sometimes the loan officer's values can get in the way of a credit worthiness decision according to organisational policy. This is one reason why Fundusz Mikro is reluctant to employ people with a banking background: they feel that the way they have experienced lending in the past could distort the lending policy implementation. ADIE sometimes found it difficult to work with loan officers from a middle class background (i.e. successful businessmen or retired bankers) who judge potential clients from their own (very different) experience.

ADIE therefore developed a scheme of involvement in credit committees and training for volunteers to make them aware of the specific market they are in.





## 7.4 Selected successful screening methods derived from the benchmarked projects

### FINNVERA: business analysts screen enterprise profitability

#### ISSUE: USING HIGHLY SKILLED BUSINESS ANALYSTS IN APPRAISAL

FINNVERA applies a business-oriented approach towards micro credit requests. The policy of FINNVERA is to accept weak collateral and/or finance micro-lending without any collateral. To compensate weak collateral, the pre-credit assessment is extensive and consists of enterprise visits and discussions with the entrepreneur. The loan officers are therefore called "business analysts" or "development managers". These officers are very well informed of the different sectors and market situation in often remote areas of Finland. They concentrate on industries and work with specific in-house databases with relevant data for and from small firms.

### Fundusz Mikro: assessment criteria depend on the loan size

#### ISSUE: TAILORING APPRAISAL CRITERIA TO THE TYPE AND SIZE OF THE LOAN

In FM, client-screening is based on four factors whose relative weight varies with the loan amount:

- motivation to repay
- entrepreneurial skills
- business viability
- cash flow coverage

Depending on the loan amount (which step in the loan cycle), the weight of these factors changes. For a first (and therefore small) loan the motivation to repay is the most important factor (weight factor 40%). The philosophy being that small loans can be repaid by high motivation only. For a fourth (and therefore bigger) loan the cash flow coverage has a 40% weight in the credit appraisal because a large loan has to be supported by a strong capacity to repay through sufficient cash flow generation.

In addition, it has to be mentioned:

- The procedures are very transparent which makes the clients partly responsible for their loan request: they know exactly what consequences they face in case of default.
- The loan size never exceeds 200% of the total assets of the enterprise in order to prevent unacceptably high levels of debt.
- The principle of stepped loans where every subsequent loan can be bigger than the preceding one if the present loan is exactly repaid on time, is a form of default prevention. The expectation of a new loan is a kind of security for repayment. A long term relationship can be built up. Loan size grows with information.

### Working Capital: all pre credit assessment is done by group members

#### ISSUE: INTRODUCING SELF-ASSESSMENT TO SAVE COSTS

Working Capital applies the minimalistic approach towards credit screening: all the work done before a credit can be granted is delegated to the peer groups or enterprise alliance. In other words the costs of loan appraisal are externalised. The standardised loan amounts from US\$500 up to US\$10,000 (stepped loans) are already fixed as long as the group considers the borrower credit-worthy. Working Capital provides training and self help tips (see chapter 6.4, page 25) to teach group members how to assess creditworthiness. The main elements are:

1. Character and commitment of the borrower
2. Feasibility of the business plan
3. Applicant's contingency plan in case of default



**ACCION:**  
non traditional  
references

**ISSUE: SOURCES OF INFORMATION FOR ASSESSMENT**

The client screening methodology of ACCION is quite intensive (and costly) but involves innovative elements which are worth mentioning:

1. Interview with the borrower's landlord, in order to check the regularity in payment of rent
2. Check at least two of the following bills: telephone bill, cable bill, credit card bill, gas bill, Con Edison bill or letters from government agencies.

**ISSUE: APPRAISAL CRITERIA DIFFERENTIATED BY THE CATEGORY OF CLIENT**



**Glasgow  
Regeneration  
Fund:**  
different levels  
of appraisal  
depending  
on credit  
amount  
and social  
accountability  
criteria

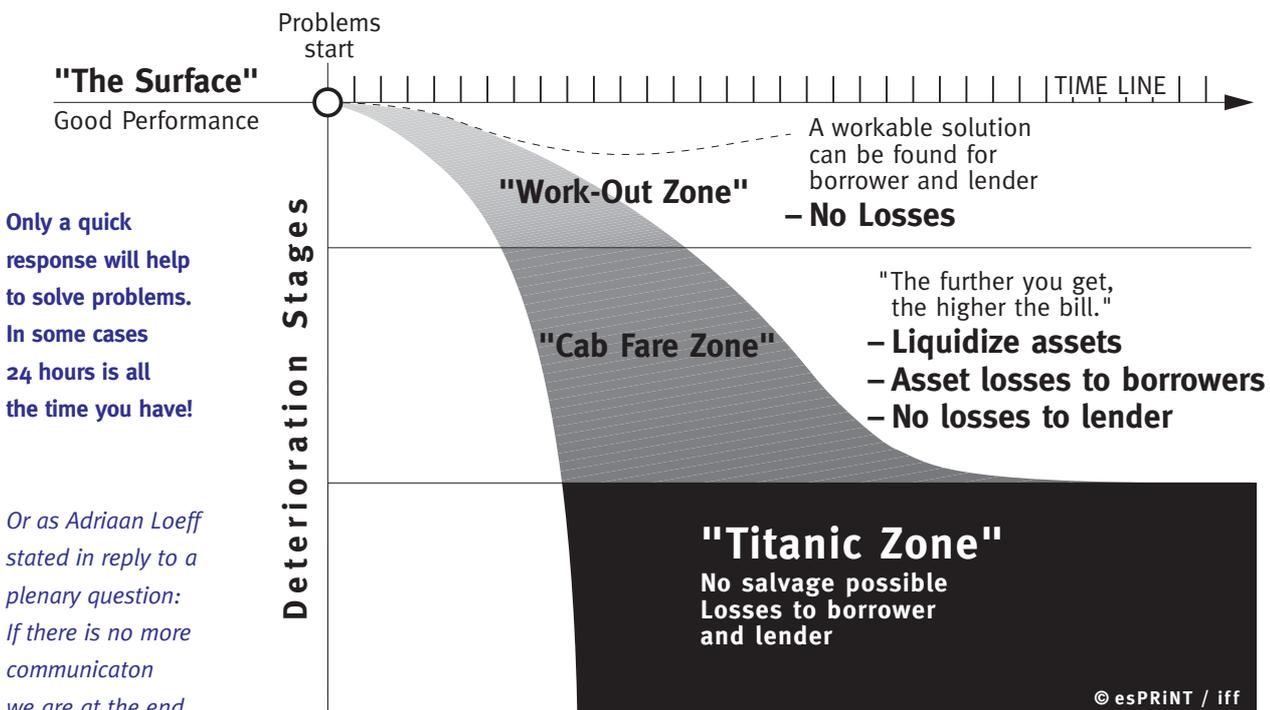
There are three levels of risk assessment in the credit approval process: small loans (1000 – 5000 pound) are assessed at local level while the biggest loans (>20,000 pound) need the approval of the board of directors.

The GRF incorporates social criteria in the credit assessment because of the source of funding (social investment funds), these criteria are:

- geographic: enterprise should be located in regeneration area
- local impact: creation of local jobs, spin off to local suppliers, creation of new businesses
- sectoral: manufacturing and service sector enterprises are encouraged as they provide spin off to other sectors

The social criteria do not alter the need for commercial viability of the proposed enterprises.

**Loan Quality Deterioration**



## 8.1 Introduction to loan monitoring

Post credit supporting strategies aim to reduce the risk of failure after the loan is approved. Monitoring of the loan performance has two functions:

1. Support the entrepreneur through provision of advisory services in order to **prevent** default
2. To enable lending institution to take **necessary action** when default occurs

The monitoring officers therefore often have a double role: advisor and collection agent. Finding a balance between these two functions in a cost effective way is the challenge they face.

## 8.2 Different aspects of risk management after loan approval

### Monitoring of the loan portfolio

Important elements in the post credit period are:

- Regular checks on individual loan sheets and the collective outstanding loan portfolio are a prerequisite for effective loan management. If, for example there are too many outstanding loans in one sector the risk of the portfolio increases.
- **In-depth portfolio monitoring** can be very helpful in exposing trends. For this, at regular time periods, special selections of data from the portfolio can be analysed, such as branches, products, loan sizes and so on.
- Also it is important to be in contact with the clients to have an early warning when problems arise due to for example changes in the family situation or the business sector of the client. Loan officers should visit clients whenever they are in the neighborhood.
- **Up to date information** on your loan portfolio is a precondition for monitoring. If the information system is not accurate or easy to consult close monitoring becomes very difficult. Early warning on possible default problems is very important in order to prevent excessive debts and loans that need to be written off.
- It is very important to have a **clear definition** on what is understood by bad debt, delinquency rate, write off, loans at risk, rescheduled loans and repayment rate.

Loan officers' responsibility for customer performance can be strengthened through **automatic delivery of late payment lists**, and discussions on this list.

### Use of co-operating support programmes

Other organisations which are involved in enterprise support or financial services and therefore somehow in contact with the client group, can be of help **to detect potential problems**. Branch information, changes on tax regimes or new city plans can have a great impact on the enterprises supported by the financial institution. It is important to have a wide network of information sources.

*The graphic on the left page (30) illustrates the typical progression of clientside problems in relation to the communication efforts taken by the borrower/lender.*

### 8.3 Traditional pitfalls with loan monitoring

- Inadequate loan monitoring systems**

Problems arise if the management information system does not provide reliable information while the staff are heavily dependent on it. The introduction of a more reliable "one day default" system can improve this situation (see *Titanic model p 30*).

Another problem observed is the implementation of a very complicated management information system which provides so much data that it is difficult to use.
- Clients in an outside portfolio**

If the loans are provided by the bank, the support organisation does not have an insight into clients' repayment. Only when problems occur will the bank contact the support organisation to see if they can solve the problem. This method of working makes it difficult for the organisation to prevent problems, to learn from experience and to evaluate the impact of their work.
- Too fast growth**

**Example:**

*In one organisation the growth has been very fast which led to an overload of work for the staff who, as a consequence, did not find enough time to conduct site visits and do early contacting in the case of late payment. As a consequence the borrowers quality became poorer and the commitment to repay decreased – both lead to an increasing default rate.*
- The monitoring officers feel pity**

Monitoring officers can be too socially oriented, if the monitoring officers feel pity for failing entrepreneurs the risk of rescheduling and renewing bad loans is a real risk to the micro-lending institution.
- Poor definitions**

Bad definition of default and debt recovery, if the lending institution has no clear definition of default and bad debt, problems with defaulters may not be detected at an early stage.

### 8.4 Selected successful methods of loan monitoring derived from the benchmarked projects

#### ISSUE: REGULAR FOLLOW-UP ON THE ENTERPRISE DEVELOPMENT

- ADIE: monthly reports to be prepared by the borrower**

ADIE asks clients to write a very short monthly report on the progress in their enterprises. This method has proved to be very effective in detecting problems at an early stage. ADIE has a high rate of successful start-up enterprises (66% survives the first two years) thanks to very intensive (and costly) "after credit" support services. On average every clients receives at least 15 hours of business support over a period of two years after the loan approval.

#### ISSUE: INFORMATION EXCHANGE WITH ADMINISTERING BANKS

- Fundusz Mikro: Accurate bank statements**

FM clients do their financial transactions through a bank which provides FM with very accurate statements on a day to day basis. This is a cost saving method as FM's own system can be less complicated and sophisticated while keeping the loan administration up to date.


**ISSUE: REDUCTION OF MONITORING COSTS/OF SITE VISITS**

**+** ACCION N.Y.:  
Only one travelling monitoring officer

Cost efficiency has been reached in doing the business site visits: one officer does all the business visits area by area instead of all loan officers travelling to all different districts. Back in the office, the "site inspector" reports his/her findings to the respective loan officers.

**ISSUE: LET CLIENTS KNOW THAT THEY ARE MONITORED**

**+** ICOF: Early response to clients due to standardised automatic debit

A client whose payment is two days overdue will receive a reminder from ICOF. This early reaction is possible because all clients have an automatic debit to their accounts on the same day each month. If ICOF is not able to withdraw the money at that particular day it can immediately send a warning.

**ISSUE: SEPARATION OF SUPPORT SERVICES AND FINANCIAL MONITORING**

**+** Glasgow R F: two monitoring officers: business adviser and after care fund manager

GRF has business advisers who are responsible for the business advisory services. GRF's approach is to ensure good repayment through intensive after care. The fund manager provides financial statements to the business adviser who, in turn, visits the client every six weeks. Should a client default, he or she will receive reminders and visits from the business adviser and, if he fails to find a solution, from the fund after care manager.

**ISSUE: COST REDUCTION THROUGH SELF MOTIVATION AND MUTUAL SUPPORT**

**+** Working Capital: "clients for clients" business support

Business support is organised by clients for other clients. The teaching clients benefit from reduced membership fees. Working Capital facilitates the contacts between new and existing clients to exchange experience and skills. WC found that entrepreneurs listen more carefully to entrepreneurs. The contacts with clients are registered on a mentorship tracking form as to increase transparency for Working Capital staff and the clients.

**ISSUE: COST EFFECTIVE SOURCES OF INFORMATION**

**+** FINNVERA: Yearly information from the tax authorities

Finnvera, as a state agency, receives yearly reports from the tax authorities on the financial situation of its clients. In addition, the business analysts ask the clients to fill in an annual report scheme. On the basis of this information feed back (by telephone, mail or through visits) is given to the borrowers as an incentive. Apart from that, the repayment information system will give the business analysts a signal from the point when a payment is one week late.

### 9.1 Introduction to the default management

The first and most important aspect of developing a sustainable financial institution is to obtain credibility in default management. Borrowers should be convinced that they must take their debts very seriously and that rescheduling should only be considered if there is no outstanding debt. Experience has shown that if credit institutions are not tough enough with the loan recovery, the repayment rate will decrease dramatically. A strategy for default management should be defined, explained to the clients, with a written statement to prevent confusion and, most importantly, implemented from day ONE.

### 9.2 Different aspects of default management

Institutions in micro-lending dealing with poor people often have a social orientation. Staff and management find it difficult to take "poor people" to court in cases of default.

Besides the moral problem for the staff, legal action is often expensive and time consuming. Especially in the case of small outstanding debts, the costs of prosecuting a defaulter exceed the loss. Nevertheless, it is important for the credibility of the financing institution that action against defaulting borrowers takes place. The challenge is to:

1. Prevent default (even if a client's business has failed)
2. reduce the costs of legal action

#### Prevention of default

Default management consists of measures to prevent default and actions that can be undertaken in cases of default. In this case, it is very true that prevention pays, as legal action is often a very expensive and difficult way of getting loans repaid.

Prevention of default should be a guiding principle at all stages of the loan cycle: client screening, credit assessment, monitoring and repayment.

In client screening it is **important to assess the capacity and motivation** of the potential borrower to repay. The traditional bank method is, first, to analyse assets/security, then cash flow projections and the client's credit history. In micro-lending these are often not easy principles to apply due to clients' level of education and his/her financial capabilities and capacity. Commitment to the enterprise, social network and punctual payments of public utility bills are non-traditional elements which can be part of client screening in micro-lending.

#### Reduce costs of legal action

Once default has occurred it is very important to take **action as soon as possible**. Successful credit institutions monitor their portfolio every day and remind the defaulter immediately by phone **and** letter. Different strategies should be applied in order to obtain the payments and prevent the institution from going to court. Another cost reducing strategy is to have defaulters reminded by their peers, relatives or volunteers before professional (paid) officers undertake action.

## 9.2 Dealing with Default

### Penalty for late payment?

There are different views in the micro-lending community on the subject of late payment penalties. The idea is straight forward: if a customer pays his instalment late, he has to pay a penalty i.e. 5-20 US\$. However, the problem is, first, that this increases the client's repayment problems. Secondly, it provides the wrong motivation.

In Fundusz Mikro's experience the clients start to think **"I am late but I will pay my penalty – everything will be fine"**. This is not what the micro-lender wants.

Therefore, Fundusz Mikro decided to use positive motivation for payment: clients pay a lower up-front fee for the next loan if they pay every instalment on time.



### Collateral or security

The issue of collateral is sensitive due to the fact that the absence of collateral often prohibits the micro-entrepreneur, and certainly those starting new businesses from gaining access to regular finance.

Therefore, innovative and creative methods and approaches must be used. Some options are illustrated in the examples included in this chapter.

### Negative impacts of using collateral

The other issue is that some organisations identified negative impacts of using collateral: FM's the mission states that: "FM does not accept any physical collateral for its loans – it believes this would weaken borrowers' personal responsibility for their repayment". In FINNVERA's experience the requesting of collateral distracts attention from the key issue in the credit appraisal, namely the viability of the business and the entrepreneur's competence.

### Involving professional collection agencies

As a measure of last resort, it is always possible to involve professional collection agencies. The advantage is that they have a professional image and can stress that the micro-lending institution is serious about debt collection. This is an important signal.

However, these agencies sometimes use very tough measures to secure repayment, which often do not comply with the micro-lending institution's objectives. Therefore you need to select the debt collection agency **carefully** to make sure you work with a reputable one.

Another disadvantage could be the cost involved in hiring such agencies. A combination of internal and external professional capacities is probably a good solution.



### How do you exert pressure in debt recovery?

A very important question in the practical process of debt collection is: *How do you exert pressure if you contact a client and ask for payment?* Nearly every loan officer in banks and micro-lending organisations has had a client who has been contacted for debt repayment who just says "so what"? The solution is a policy of creating as many levels of increased debt recovery pressure as possible.

As Steve Walker of ART remarked:

*"don't give away potential for a higher pressure level too early".*

As an example, see the following eight levels of increased pressure, based mainly on Fundusz Mikro and Accion New York's practises.

1. Phone call and letter from the loan officer with the request for payment
2. Late payment = increased upfront fee for next loan
3. Threat to deny access to new loans
4. Involvement of co-signors who are threatened with denied access to new loans
5. Involvement of internal collection officer
6. Involvement of external collection agency
7. Making use of collateral – taking away symbolic pieces
8. Threat of court action

You may be able to think of more levels of pressure. If so, use them!

## 9.3 Traditional pitfalls with the default management

### Reputation of lending institution

It is very important to build a reputation of being a serious lending institution right from the beginning. To be taken seriously takes a long time, but losing a reputation and credibility can happen very quickly. Especially in group lending, there is a risk that peer pressure could work aversely (e.g. if one member stops paying all the others will follow because they have already lost their right to receive further loans) if the lender is not strict with defaulters.

Below we describe some practitioners' experiences.

### Negative "word of mouth"

Two organisations did not want to bring clients to court and ended up with the reputation that loan default carried no consequences. Both organisations changed their strategies in order to regain public confidence and they have found this very hard. "Word of mouth" has worked very strongly against them.

### Restrictions from the board

The board of another organisation does not want to be tough with defaulting clients because it is against their social orientation. *The objective of the organisation is to support viable businesses and not to disburse and collect loans.* If the business failure is not the borrower's fault, they try to reschedule the loan or to give a capital holiday. Similarly the organisation not want to apply penalties for people who repay late. Unfortunately, as a consequence, there is a real risk that this organisation will get a reputation of being a soft institution giving away money to poor people: a situation which is easy to create and impossible to turn back.



## 9.4 Selected successful methods in default management derived from the benchmarked projects

### ISSUE: DIRECT PERSONAL ACTION TO MANAGE LATE PAYMENT

Most of the micro-lenders we contacted had one view of default management: you have to contact quickly and in person. It is certainly worth sending increasingly tough letters to the client to ask for payment but, in addition, personal contact must also be made. This provides an opportunity to obtain an explanation for late payment and presents more initial pressure than a letter.

#### ACCION NY: One day late policy

Accion New York has a **one day late = telephone call policy**. Due to their strong cooperation with Chase Manhattan (providing standardised paying-in slips etc.) they are able to find out if an instalment is even one day overdue. In that case, they send out a letter and do everything possible to contact the client on the phone on the first day after the payment was due. If clients avoid telephone contact, Accion goes as far as sending the collection officer to sit in front of the client's house, so that everyone in the neighbourhood knows what is expected of the client.

#### Weekly repayment meeting

A weekly repayment meeting where the status of all outstanding payments and the steps taken is discussed for immediate action (letters, telephone calls)

#### Change of person responsible for collection

The person working in loan administration is also in charge of repayment behaviour ("collection officer"). Whenever loan officers' stop having an effect, this person takes over. Clients are often shocked into resuming payment by the fact that the case has been passed on to another level. Once payments are up to date again the responsibility is given back to the loan officer.

### ISSUE: FORMER CLIENTS AS DEBT COLLECTORS

#### PBT and Working Capital

PBT and Working Capital both developed models of using former clients as debt collectors. The idea behind that is, first, that clients 'speak the language' of other clients and, second, that this supports the rhetoric that non-repayment by one client is a problem for all clients.

### ISSUE: POSSESSION OF PRESSURE MEANS

#### Fundusz Mikro: Client signs blank bill of exchange ("Wechsel")

Although FM relies very much on the pre-credit screening, they have the option of taking legal action with a blank bill of exchange. As FM does not accept any collateral, this document is the only officially recognised document which allows the holder to claim any amount from the borrower. This makes the court proceedings much easier and has a strong psychological effect.



#### ISSUE: GROUP LIABILITY IN CASE OF DEFAULT



**Working Capital:**  
Peer group members operate a "buffer fund"

All the members in the peer group are obliged to put 10% of their registration with the credit reference office as a 'buffer fund'. This fund can be used in the case of default by one of the members. The buffer fund helps to prevent all the group members being excluded from further borrowing.

Another very effective "repayment pressure" method used by Working Capital is the registration of all loans at the credit reference office. In the USA it is very important to have a clean credit record, and people try their hardest to prevent being blacklisted in the credit registration office. Further, a high percentage of their clients are actively trying to build up a positive credit history.

When default occurs the group should first try to find solutions, if these fail the debts are handed over to a commercial debt collection office which receives 29% of the money recovered. This facility is still cheaper than starting legal proceedings, and avoids the micro-lender being seen as weak with regard to debt collection. However, the performance of the agency in its first month is not very impressive: it collected just 19% of the defaulted loans that were passed to it (but many of these were quite old).

#### ISSUE: EXISTENCE AND EXECUTION OF REAL THREATS



**FINNVERA:**  
Threats to take legal action and report to credit registration office

FINNVERA's policy is not to accept collateral, such as property, from their micro-loan clients. As a consequence they have to apply other measures to ensure repayment. The threat of starting legal proceedings and registering the debt in the central credit register is often enough to induce clients to settle or negotiate their loans.

#### ISSUE: SELECTIVE PROSECUTION TO REDUCE COSTS



**ADIE and GRF:**  
only cheating and unfair practices are followed by legal action

The costs of legal action always exceed the money which can be recovered from defaulting clients and, therefore, ADIE and GRF have decided only to take legal action as a warning to unscrupulous or dishonest clients. In all other cases the organisations would try to find a solution with the borrowers (e.g. rescheduling, capital grace period, ...)

#### ISSUE: PRODUCTIVE FAILURE

Sometimes a client's business idea does not work, even with alterations. In this situation, increasing repayment pressure has limited success. It is important that clients to see business failure as a lesson worth learning, not least for future attempts at entrepreneurialism. This also motivates them to try their best to make repayments. They should be given the impression that if they tried as hard as possible to make the business work and to meet repayment obligations, the organisation will help them start again. This will motivate them to repay as much of the loan as possible instead of just failing to contact the organisation.

## The best strategies to reduce costs and reach sustainability

### 10.1 Introduction

In this chapter, we would like to draw general conclusions regarding all of the issues mentioned in the previous chapters of this handbook and the best solutions to those issues.

In addition, we will give our overall views on the present developments and state of operational methods and procedures of the micro-lending industry in Europe. This is of course only based on the limited "sample" covered in this project.

### 10.2 Summary of issues and their best solutions

#### 10.2.1 Institutional setting in the framework of overall objectives

##### "Structure follows strategy"

The principal issue is the question: "what is the core objective or "raison d'être" of the organisation". Following the general rule that "structure follows strategy" the objective of the organisation decides the structure and essentially all operational procedures and methods.

*Are we, or do we want to be, a professional and sound financial institution, or are we a micro enterprise support organisation aiming for socio-economic development and employment generation?*

This crucial choice of core orientation decides most of the aspects of the organisational structure, client selection and operational mechanisms.

The question we have asked ourselves is whether this "choice" is really a black or white situation? Is there a risk of getting "stuck in the middle". Or is it possible to find solutions and practices that make it possible to serve a combination of both practices.

##### "Social or business objectives"

A workable solution for the question "social or business objectives" that has been found and is practiced by many institutions can be summarised as follows:

*Our clients or target group are the weaker members of society or the economically excluded, but once they have been accepted to be our client, we apply strict, transparent and business-like methods and procedures.*

In this way the (social) developmental orientation is reflected through the basic selection of the clients, while the methods and practices applied are based on clear and business-like methods, befitting a professional financial institution, and securing continuity of operations. Creative solutions (of which some have been illustrated in this study, such as group lending, promotional strategies, and collateral solutions) are needed to reach the target group and at the same time run a sound operation.

##### How to mobilise funds?

The objective or mission of the micro-lending organisation also has great influence on the options to mobilise funds for lending. Most institutions are re-financed by donations, governments, local authorities, or the general public.

## The best strategies to reduce costs and reach sustainability

The mission, or envisaged effect (impact) of the institution has to "sell". Funding parties must be convinced, mostly on more ethical or socially motivated grounds, to invest in the micro-lending institution. Therefore, the "solution" to this issue is that a clear and appealing objective of the organisation is promoted, in order to generate funding sources. The implementation of this objective has to be made transparent through disclosure of key information.

Some ML institutions have been creative in mobilising funding sources from the general public, which is the best and most objective (less politicised) source of funding (see also the respective chapter).

The issue of operational losses also arises. Funders mostly allow for some loss coverage, or provide subsidies. However, this may never be an "excuse" to leave "slack" or inefficiencies in the organisation's operations. It is especially important that lending conditions and strict repayment criteria are not relaxed because of available coverage of losses.

### "Graduation" of clients

The so-called "graduation" of clients from being clients of a micro-lending organisation to becoming a "bankable" client for the established banking sector is another issue.

It is assumed that graduation is a general objective of most institutions. A good solution is co-operation with the established banking sector at an early stage, where the micro-lending organisation "grooms" the client into becoming a bankable client. Identify bank partners that are willing to take over your clients. Develop a mutual referral system!

### 10.2.2 Attracting clients

#### Clients recruit clients

The core issue found in the study is to **attract "the right client"** (in terms of fitting the objective of the organisation) **in "the right way"** (in terms of the least effort, risk and costs).

The funnel described in the relevant chapter illustrated some aspects of this issue.

The best solutions are the recruitment of new clients through existing or potential clients, (clients recruit clients) by using the group-lending approach (an individual client has to find others to form a group), or simply through word of mouth, possibly with a bonus system attached. Another successful solution was the use of "others". Other related institutions or (local) government authorities can play an important role in the (pre-) selection of clients, **but you have to show them what types of client you are looking for. Implement a learning referral system.**

Of course, having a perfectly tailored financial service for the envisaged target group is also proven to attract new clients through the image among the existing clients.

## The best strategies to reduce costs and reach sustainability

### 10.2.3 Services and pricing

- Do not mix** The clear lesson learned is: focus on one kind of service and do not mix business support with financial services. If your organisation wants to do both: separate income, costs and responsibility. After you decided on your core activity, limit the products and services you offer to the essentials needed. Think about working in co-operation with other organisations who might be able to offer your services to the benefit of your clients.
- Outsourcing** Where considerable support is deemed necessary, "outsourcing" of business support services to specialised agencies is a good solution. In other cases credit officers can provide limited advice, if transaction costs are kept under control. Or you connect clients for identified support issues to experienced volunteers.
- Pricing** Pricing of financial services is always under heavy discussion, as it reflects most clearly the perceived contradiction between the social development orientation and the professional financial services orientation. However, the **price of credit** for micro enterprises has proven to be less relevant than the **access to that credit**. Therefore, the best solution is to secure business continuity and use cost coverage pricing. This also prepares clients for possible graduation. Risk reduction strategies (such as group lending) should then reduce the cost (loan losses and transaction costs) so that pricing can be set as low as possible.
- Different group lending** Group lending is not always peer group lending as practised by WORKING CAPITAL or GRAMEEN BANK. In western societies, it could prove to be more efficient to use individual loans for the less excluded client groups but deliver them through a group of co-borrowers as shown by the group lending methodology used by ACCION and FUNDUSZ MIKRO.
- Standardise** Standardised credit appraisal and delivery (including electronic banking) will further lower costs of operation, allowing lower interest rates. Some examples have been given in the chapter on service delivery.
- Transparency** Transparency (internally as well as externally) is important. The client who perceives the credit to be expensive can then understand the actual costs to be covered.

### 10.2.4 Pre-credit decision risk management

- Creativity** The essential bottleneck for the traditional banking industry is the objection to undertaking time-consuming credit appraisals for loans as small as a few thousand dollar. ML institutions have found creative solutions to reduce the costs of this appraisal. Some examples are to tailor the appraisal criteria to the type (repeat/stepping loans) and size of loan. Others have been successful in self-assessment methods in groups.
- Standardise** For all these methods, selection based on the character of the client is very important. Standardisation of appraisal techniques helps again to save costs. The best example is the standardisation of simple cash-flow tables for small investments.
- Delegate** Another solution, is the "delegation" of (part of the) creditworthiness assessment to other agencies. All preparation can be done by others, while the final decision rests (of course) with the ML institution.

## The best strategies to reduce costs and reach sustainability

### 10.2.5 Post-credit decision risk management

#### Portfolio quality

The critical issue here is to keep the quality of the portfolio at its highest level. In other words, keeping arrears and default as low as possible.

An essential tool in this respect is timely information through a highly effective loan administration and management information system.

Most ML institutions visited have developed their own tailor made loan tracking systems (see case studies). These are considered to be the backbone of post-credit decision risk management. Co-operation with an established bank for control of transactions is also an advantage.

#### Strict follow-up

This should be combined with a very strict follow-up system for overdue payments. Consistency and a clear business-like and serious image has proven to be very important.

Monitoring clients through follow-up visits is a good tool for risk control, but is costly. Reporting systems should provide control, in the first instance, and visits be made only if problems occur. Also, this role is sometimes delegated to other (business) support agents.

#### Transparency of rules

Transparency of the rules of the loan, especially the consequences in the case of default and clear definitions of what "overdue" means, will help to convince the client to make timely payments.

In some cases information from commercial agencies, or tax offices is used to assess the risk and quality of the loan.

### 10.2.6 Dealing with default

All methods and approaches described in previous chapters aim to avoid default.

#### Legal action

In the case of default, most organisations (naturally) firstly analyse the core reason for the default. If the cause is due to gross mismanagement or illegal action by the client, immediate legal action is mostly taken. In other cases, the threat of legal action can often turn around the situation.

#### Pressure levels

However, all ML institutions say that legal action is always a measure of last resort that they will take, in order to establish and maintain their image and credibility. Before that, a system with "levels of increased pressure" (see p 36) was found to work best.

In group-lending systems, a solution is often found within the group.

Simple systems, to avoid high costs of legal action are being used, such as pre-signed cheques and "wechsels".

## Concluding remarks on micro-lending operations in Europe

Through the study that is the basis for this handbook, we have found that the micro-lending "industry" is gradually becoming established, albeit at present on a relatively small scale.

Micro-lending is gradually finding its place between social security systems, providing support for the livelihood of the poor, on the one hand, and the established banking sector, providing credit on commercial terms to the established business community.

Therefore, it is important that ML institutions continue to distinguish themselves from traditional banks, in order to maintain their specific role, and justify their existence.

It is the view of the research team that **facilitating access to credit**, which enables the particular target group of the ML institutions to be active in employment and income generating ventures, is the core mandate of the ML institutions.

The access to credit for this particular target group has to be "costed" by the ML institution and "paid for" by the client, generally resulting in slightly higher interest rates and tariffs than with the regular banks (which do not supply this target group anyway). However, this is perfectly in line with the mechanism of balancing risk and benefit, and sustaining an ongoing business.

Business that can be realised by intermediate financial institutions are under pressure. Therefore, competition with the regular financial sector institutions can not be on price (because higher risk must be covered by higher interest rates) but must be fully based on accessibility and "client-friendliness", or "client orientation".

On the other hand, fund-raising for social investment, where investors are prepared to accept lower returns, leads to lower-cost capital, which leads to the potential for higher margins, creating better risk absorption and, ultimately, giving them the ability to accept more risky (micro and start up) clients.

The above mentioned principles lie at the heart of successful ML operations.

In this handbook we have given an extensive number of examples of methods and instruments chosen by ML practitioners operating successfully within the framework of their mission.

**We hope that the existing and new ML institutions will find inspiration and useful practices in this book, to optimise their own operations.**

**We are grateful to the European Commission for providing us with the finance that allowed us to learn about microlending. Even more, we are grateful to the microlenders who taught us what we learnt.**

*Two Members  
of a peer group  
(Working Capital, Boston)*



## Annexlist

- Annex 1: Case study of the micro-lender Accion New York
- Annex 2: Case study of the micro-lender ADIE, Paris
- Annex 3: Case study of the micro-lender FINNVERA, Finland
- Annex 4: Case study of the micro-lender Fundusz Mikro, Poland
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D-20095 Hamburg

phone +49 – (0)40 – 309 691-0  
fax +49 – (0)40 – 309 691-22

[info@iff-hamburg.de](mailto:info@iff-hamburg.de)

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## Benchmarking case-study

### ACCION, USA

*Date of visit: February 03 and 09, 1999*

*Executed by Jan Evers and Stefanie Jack, IFF, Elaine Kempson, PFRC*

## Objectives and vision

ACCION International's main objective is to fight against poverty through micro-lending. "What they (poor people) need to break free is a little credit - a loan as small as \$75. Now they can get it. ...ACCION International is dedicated to bringing financial services to these smallest of small business people..."<sup>1</sup>

ACCION has declared as it's major vision to accomplish the above objective through achieving sustainability. This vision is based on three arguments:

- The total amount of money which is necessary to support poor people in the US and world wide is much higher than one organisation could raise from donors.
- The experience from Latin America where some of ACCIONs micro-lending initiatives became self- sufficient – in particular BancoSol.
- In addition, ACCION made the experience that using grant money from the government is dangerous because it is usually delivered under conditions for distributing which could prove unfortunate for a successful lending methodology.<sup>2</sup>

ACCION U.S. Initiative set itself the following objectives:

- **IMPACT:** To increase incomes, build assets and create jobs by supporting the initiative of self-employed women and men.
- **SCALE:** To reach enough micro businesses to have a significant impact on the economic revitalisation of distressed communities.
- **SELF-SUFFICIENTCY:** To develop a microlending model for the U.S. that is self-sustaining – able to cover its costs through fee and interest income.

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<sup>1</sup> ACCION Internet Sites, [www.accion.org](http://www.accion.org), Homepage

<sup>2</sup> Livingston Parsons, Senior Director ACCION U.S. Operations said in an interview during the case study at 3.02.1999 "stay away of state money because the conditions to get it destroy the methodology for successful lending". The only exception he made was money out of the CDFI fund.

## Short history

ACCION International was founded in the year 1961 in Venezuela as a student-run volunteer effort. Initially they started their program as aid assistance and peace corps in Venezuela. Over the next ten years, ACCION started programs in three more countries: Brazil, Peru and Colombia, placing over 1.000 volunteers and contributing more than \$9 million to development in some of the poorest communities of Latin America.

In 1973 ACCION staff in the city of Recife, Brazil started issuing small loans for supporting microenterprises. Within the next four years ACCION had provided 885 loans to small enterprises in Latin America. Within the next ten year ACCION helped start micro-lending programs in 14 Latin American countries.

At some stage in that process ACCION decided to concentrate its activity on lending and give up other assistance programs.<sup>3</sup>

In 1991 ACCION brought it's programme to the U.S. Starting a micro-lending model program in Brooklyn, New York. Over the next five years, ACCION's U.S.Network adapted it's Latin American lending model to the different context of the U.S. Today the U.S.Network has micro-lending programs set up in 6 American cities.

By the end of 1998 (10/98) the U.S. Network had disbursed cumulative 14 Million US\$ to 5.110 low-income entrepreneurs.

## Organisational structure

The head office of ACCION is placed in Boston, Massachusetts. The head office overseas currently a total of 26 programs. The ACCION head office involves 45 people. A President and CEO, Financial Controllers, a fund raising group, a group for Latin American Operations and a group for the U.S. Network Operations.

ACCION consists of a network of 20 Programs in Latin America<sup>4</sup> and 6 programs in the United States. In the US, each program operates independently, raises its own funds, does it's own client marketing and sales procedures and operates it's own financial controlling and even loan their product development. However, ACCION headquarters assist in providing human resource strategy development, in developing a communication strategy, in setting up a joined reporting and in fundraising with national organisations. They major incentive to be part of the ACCION network is the fame of the name (a international brand so to say) and as a

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<sup>3</sup> Livingstone: "From our experience Micro-lending organisations are either good in lending or in assisting"

<sup>4</sup> Programs in Latin America are currently placed in Argentina (one program), Bolivia (two programs), Brazil (one program), Chile (one program), Columbia (four programs), Costa Rica (one program), Ecuador (one program), Guatemala (two programs), Mexico (one program), Nicaragua (one program), Panama (one program), Paraguay (one program), Peru (one program).

consequence of a shared database and marketing strategy a strong public relation position.<sup>5</sup>

The US: network has placed its programs in Chicago, El Paso, New Mexico, New York, San Diego and Texas. Within this network, information on the outstanding loans is shared within one database to deliver national figures. This research project has concentrated looking at the U.S. Network and in particular at the New York program.

The ACCION New York is structured as follows:

- The N.Y. program has a total staffing of 7 people. President and CEO of the N.Y. program is the first person to mention. One Office Manager who oversees the loan officers is in charge of book keeping, delinquency collection and loan administration. Two Loan Officers are in charge of client recruitment, client appraisal and client support.
- Further more Site Inspector is in charge of conducting all site inspections prior to loan disbursement and is in charge of delinquency collection after 30 days of delayed payment. One Receptionist is in charge of dealing with all incoming requests and of performing all orientation meetings which take place twice a week.
- Further more, in the future one New Business Manager will be in charge of all Marketing and PR activities of the office. This person will also be in charge to oversee 4 new volunteers which will start in the N.Y. office in due course. The volunteers' responsibility will be to help with client support, do support fund raising activities, to reinforce marketing and PR activities and to cover systems and technology problems.

## Target Group and client profile

### Target group and client profile ACCION U.S. Network

40% of all ACCION U.S. Network clients are women. 87% are members of a minority group and 50% of all clients do possess a high school education or less.

"They (ACCION clients) start their business because their sub- or minimum-wage jobs do not provide enough income to make ends meet, let alone dream of buying a home or sending their children to college"<sup>6</sup>

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<sup>5</sup> For the US network, currently there are some plans developed to strengthen the ties between the programs. However, in March 1998 the New York program became complete independent of the head office in Boston and the question is if the independent programs share the commitment of the head office for stronger ties.

<sup>6</sup> ACCION US Network 1997 Annual Report, page 2

30% of all U.S. Network clients work out of a store front, 23% operate from the street or in a market, 39% operate a home based business. ACCION clients are typically in business for around 3 years, one out of 4 less than a year. 25-30% of the clients have the sole intention to rebuild a positive credit history with the programme

### 1.4.2. Target group and client profile ACCION New York

Target group, client profile, facts and figures, financial services and credit delivery methodology differ slightly in the respective programs. As the benchmarking team has concentrated on visiting and interviewing the New York program the following chapters will describe the situation in New York.<sup>7</sup>

ACCION New York works best for people who:

- Own their own small business
- Are committed to their business
- Are self motivated business people
- Can prove self discipline and commitment towards ACCION

*"Clients of ACCION New York typically have lower than average incomes, with a median household income of \$24,948 for a three-person household, compared to the national median of \$41,043. The median asset level of clients' businesses is less than \$3,000 and the median monthly take home income from the business is \$1,200. 98% of its clients are Hispanic. Over 50% work in the service sector."*<sup>8</sup>

Clients coming to ACCION New York are active in the following businesses: taxi driving (a large percentage of all group lenders are taxi drivers), street vendors, seamstressing, sandal making, hairstyling, cooking (catering), cleaning, and nursing.

45% of all loans in the New York program are taken as group loans, whereas 55% of all loans are individual loans. 42% of all lenders are women. 92% of these women are loan parents. 50% of all lenders use the income from the business supported by ACCION as the only income, 50% use it as an additional income.

ACCION New York targets people who have set up their business for at least one year. They do not support any start ups. However, this does not mean that the clients have to be perfect running businesses. The requested business experience is often on a marginal basis, for example a home based business and sometimes it is enough that the loan applicant has to prove "some activity" in the type of business without having been an entrepreneur himself. The crucial point is that there is not only a vision but a practical understanding about the product, the local market and the customers.

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<sup>7</sup> It is important to note that the New York program is the biggest of ACCION in the US, is one of only two US programs who provide group loans and went through some strong changes in 1998, in particular independence of the headquarter, a new C.E.O. and in many respects a turn around in portfolio quality .

<sup>8</sup> ACCION Internet Sites, [www.accion.org](http://www.accion.org), About ACCION, Meet our clients, ACCION New York

## Facts and figures for the New York program

		New York Program	Total U.S.
1.	Number of loans disbursed since inception	2.066	5.110
2.	Amount of loans disbursed since inception	USD 6.568.594	USD 14.816.806
3.	Average loan amount	USD 1.264	USD 2.739
4.	Average loan term in months	7-15 months	not available.
5.	No of employees	7	
6.	Total number of loans disbursed in 1998	217	888
7.	Amount of loans disbursed in 1998	USD 956.444	USD 3.363.294
8.	Loan balance outstanding for 1998 (31.10.98)	USD 788.676	USD 3.344.228
9.	Administrative expenditure for 1998		
10.	Credit losses/Write off's for 1998	11% <sup>9</sup>	4,6%
11.	Delinquency rate for 1998	13,2% <sup>10</sup>	not available
11.	Income from clients in 1998		
12.	Re-financing costs (average)		
13.	Estimated rate of survived enterprises (after three years)		

<sup>9</sup> this (for ACCION standards) high figure is currently falling due to strong changes in the loan and collection policy implemented by the new C.E.O. in 1998 (see section 2) which is reflected in the Delinquency rate for all loans made after 30/09/97 of 8,1%.

<sup>10</sup> please note that ACCION calculates this figure (provisioning for losses) very careful: after 30 days of late payment the full outstanding loan amount (and not only the outstanding instalment) is seen as delinquent

# Financial services and credit delivery methodology

## Client recruitment

The New York program is known by the local population mainly through word of mouth. 80% of ACCION's New York's clients did learn to know about ACCION through word of mouth. ACCION is reinforcing the word of mouth process by an award system for all clients who refer a new client to the system (see section 2).

ACCION is distributing their flyers and information material through existing organisations of racial or religious minorities. Further more the local community is kept informed about ACCION through TV, newspapers, magazines and other publications. ACCION has started the attempt to work together with banks on referrals of clients who the bank does not serve. This however has not proved very successful so far. Further co-operation with several banks is planned.

The second step after distributing information material, flyers and advertisements is an information meeting which takes place several times a week in the New York office. These meetings are attended by between 5 to 15 people. 13,5% of all clients attending these information meetings end up with a loan disbursed.

One of the biggest problems of ACCION New York in the client recruitment is, to fight against the perception of being one of the uncountable loan sharks lending money in poor neighbourhoods in the US. This is one reason why at the moment word of mouth is so dominant for recruitment. Only if other clients tell that ACCION is no loan shark, people can trust and become new clients. Many clients of ACCION made very negative experience with money lenders before and are very careful in "risking everything again."

## Credit delivery methodology

The first step for each client who is interested in receiving a loan from ACCION is to attend the first information meeting which is called orientation. The orientation takes place in English and in Spanish and has a duration of about 45 minutes. During this orientation clients receive information about the form of ACCION loans, administration details, costs of the loans, penalties if loans are not paid back in due time and loan collection procedure.

After the orientation meeting ACCION does hand out a loan application form which is to be completed by the client and supplemented by a number of "security documents" (regarded as the second step in the loan delivery methodology). The application form asks for personal details as well as business details. Further more ACCION asks for security documents as supplement to the application form.<sup>11</sup>. Important to note is that many of ACCIONS clients are not literate or feel insecure in writing. The loan officers

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<sup>11</sup> Details see chapter 1.8. Risk Management

of ACCION are happy to assist in filling out the forms (without asking much questions why).

As the third step the loan officers conduct an intensive investigation on the clients financial standing. The loan application will be reviewed by checking on the credit history of the client, talking to the people which the applicant has appointed as personal and business references and by making a site inspection in order to visit and check the clients business premises. There is an officer centrally doing all the site visits, which gives synergies in travelling time.

Clients whose application is turned down will be referred to start up help desks or something alike. A new application can be handed in by these clients 6 months after the first application.

The fourth step is that the loan officer presents the loan application with all relevant details to the Internal Loan committee held every two weeks. The Internal Loan committee consists of all loan officers in the New York program, the office manager of the office and the President and CEO of the New York program. After the presentation of each loan application the committee votes.

Approximately 30% of all loan applications fall through this approval process. Should the loan application be above 15.000 US\$ the credit decision will be carried to the external Credit sub-committee consisting of board members.

Once the loan is approved by the credit committee the client will be "walked to the bank" by one of the loan officers with a cheque and collects his loan (to make sure that they do not hesitate to use the cheque and know where the branches of the bank partner Chase Manhattan are).

## Cost and terms of services

The current product of ACCION New York is a stepped loan to individuals. 50% of these credits are administered as group loans and 50% as individual loans. Minimum loan size of the New York office is 500 US\$, maximum loan size 25.000 US\$.

There are two different prices for group loans and for individual loans.

The annual interest rate for all loan products is 16%. Group administered loans have an additional service charge of 5%, individual loans 6%. This additional service charge is reduced directly from the loan amount handed out.

Late payment fees are calculated as follows:

Days	1-10 days delayed	11-30 days delayed	Each additional month delayed
Fees	US\$ 20	US\$ 30	US\$ 20

A relative new product is a starting loan step of up to US\$ 5.000. This targets the market of more advanced business men who found the small amounts of money not attractive enough to apply for. However, the loan conditions for these loans are tougher: a more advanced business with a strong cash flow performance is required.

Currently, it is investigated if there might be a potential for selling insurance products (in particular life insurance and business related insurance) in co-operation with a mainstream financial institution.

## **Loan administration and MIS**

Loans to clients are issued with cheques paid out at the bank partner Chase Manhattan without further costs (in many US cheque cash shops fees are as high as 10%).

The repayment is done with vouchers for deposit slips ("client coupons") which are again issued by Chase Manhattan and can be paid in to every branch of Chase Manhattan. The amount is transferred to the account of ACCION at the next day. Bank statements are sent to ACCION on a daily basis (online). With this system ACCION is able to realise clients delayed payments within 24 hours and is prepared to react immediately.

There is a DOS based database for loan administration which is used by the office manager. Although with this system ACCION is having some stability problems and problems to identify group administered loans, the system delivers a list of "one day late"-clients on a daily basis per responsible loan officer. This allows an immediate follow up by the loan officer. Currently ACCION US is investigating in new products for administration. The implementation of a new computer system is planned to take place next month.

## **Risk management**

### **Credit worthiness evaluation**

First and essential criteria for the credit worthiness evaluation is, whether the clients business exists at least one year. ACCION does not support any start up's.

Furthermore the loan decision by the credit committee is carried by three major considerations:

- a) Need for a loan
- b) Pay back potential
- c) Character of the client, entrepreneurial motivation

As mentioned in chapter 1.6.3. ACCION is conducting a very concentrated and sophisticated credit appraisal process. The process starts with the credit application form which asks for the following information:

**Personal borrower information:** Place of employment; Borrower take-home net income; Information on borrowers household; **Business information:** Location; description of business; number of paid workers; credit history of the business; assets of the business; business liabilities; loan request information; personal and business financial information.

As a supplement to the credit application form ACCION is asking for the following information:

- a) At least two of the following bills: Telephone Bill; Cable Bill; Credit Card Bill; Con Edison Bill; Brooklyn Union Gas Bill; Letters from any government agency.
- b) One of the following documents: Current Passport of native country; Resident Alien Card
- c) Drivers License or Identification Card
- d) Social Security
- e) Original copy of home lease and business lease, if available
- f) Current monthly Bank statement or a check from the account, if available
- g) Credit Cards, if available
- h) Co-signer sheet for individual loans and co-signer's 4 most recent pay stubs

As mentioned in chapter 1.6.3. the loan officer of ACCION is doing a thorough review of the above material. Her or she will check the credit history of the client, will review his last bills, will talk to his landlord and will talk to some of the people which are mentioned as personal and business referrals in the application form. As a last step the clients business will be visited.

In order to summarise the scope and validation of data which is regarded by ACCION New York we would like to list all requirements to the client prior to approving his loan:

- a) Orientation Form, attend first meeting with loan officer
- b) Fill in loan application form and discuss financial analysis
- c) Provide references
- d) Provide ID
- e) Allow inspection of business site
- f) For groups confirm strong sense of solidarity and joint liability
- g) Credit evaluation
- h) Landlord reference
- i) Liens on vehicles

## Ensuring payment and debt recovery

The debt recovery procedure of ACCION is very standardised and follows a pre-structured path. The office manager receives bank statements on a daily basis and consequently can track delayed payments after one day. A default list is printed by the office manager every day and distributed to the loan officers on a daily basis. Once a week a debt collection meeting is held, which is attended by all staff dealing with loans.

Should the client be delayed with his payment for one day, he receives a telephone call from his loan officer reminding him to pay. Should payment not be received the next day a first letter will be issued to the client with a copy to the co-signer. As of day one for delayed payment a "Late payment fee" is charged. (see above)

The loan officer is in charge of chasing the client with telephone calls and letters for the first 30 days of default. Should there be no success in collection of money after 30 days the collection officer (at the moment the office manager) will take over from the loan officer after and be responsible for collection of money and chasing the client. "*A different voice being in charge of the money collection very often makes things progress*"<sup>12</sup>. Tougher letters will be sent by the office manager, he will call the client and visit him and his business personally.

Should the payment not be received after 60 days the account will be recommended for legal action and the case will be brought to court.

In 1998 a couple of tighter collection procedures were implemented by the new CEO and seem to prove successful. One of them is a weekly collection meeting where loan officers, collection officer and the CEO discuss trouble cases and the status of action.

## Covering losses

For the case of a defaulting loan, the main source for covering losses is the liability of the guarantors: for group loans this are the co-borrowers which depend on further access to credit and therefore have to make pressure on the defaulted borrower to pay back or taking over responsibility for pay back themselves. Individual loan ACCION asks for a co-signer who serves as a guarantor for the loan. Requirements on the co-signer are that he must have a continuous working history (at least two years working for the last company) and that he must get paid by cheques in order that his salary could be garnished in case the loan is not paid back in due time.

Should the borrower not be able to find a co-signer he has to prove personal or business assets and use those as a guarantee. A UCC liens will be issued on assets in this case.

A group loan is secured by the group members who guarantee for each other to pay back if one of the group members defaults. For taxi drivers a vehicle liens is issued.

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<sup>12</sup> As mentioned by the loan officer Evelyn Lassalle and her colleague during our interview

Should the loan be higher than 4.000 US\$ collateral in form of assets are requested. However, collateral has proved not very successful in covering losses due to low market prices of used parts and high transaction costs in the selling process. Therefore collateral stays mainly a psychological security.

## Sources of funding and operational and financial sustainability

ACCION New York is in the situation of a fairly unlimited loan capital due to the pressure the Community Reinvestment Act (CRA) is making on banks to care about local investments.<sup>13</sup> In total there are 68 major banks which lend money to ACCION. The prime lending rate in U.S.A. is between 7% and 8%. Due to the CRA banks are lending money to ACCION for an interest rate of 3% to 4%. In addition, ACCION can afford to ask banks for a share of 5% to 10% of the loan money given as a support for lending to clients who are refused by banks.

In addition, ACCION's capital is raised from co-operations, foundations and individuals, - 90% of these donations are raised from large donors, only a very small amount of the money is raised from individuals.

In 1999, the Community Development Fund Institution (CDFI) will also finance an essential amount of money for ACCION New York.

Nevertheless, currently 45% of the operational costs and loan losses of ACCION New York are covered through their own income earned by lending money. The remaining 55% is covered through donations.<sup>14</sup> For the financial year 1997, the six US programs of ACCION range in terms of self-sufficiency between 13% and 58% with the New York program at second place (38%).<sup>15</sup>

## Human resources

For the whole ACCION US Network the quality of loan officer knowledge, experience and general staff quality is an issue for improvement. One important aspect is the high staff turnover seen the last years and a burn out syndrome.<sup>16</sup> As a result a policy for incentive programs and more support and training is under implementation.

Currently, ACCION New York implements an employee incentive system based mainly on the quarterly portfolio quality and loan growth. The incentive is responsible for 10-20% of the salary.

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<sup>13</sup> According to Terry Ludwig, C.E.O. and President of ACCION New York

<sup>14</sup> Quote Terry Ludwig, C.E.O. and President of ACCION New York

<sup>15</sup> See the ACCION U.S. Network Annual Report of 1997, page 4

<sup>16</sup> according to Livingstone Parsons in our interview

In addition, a scheme to link the CEO's salary with crucial performance indicators as portfolio quality is under discussion. This shall prevent experiences, where loan turnover is dominant for performance appraisal.

The challenge in finding efficient loan officers is, that they should know the type of clients and their language and also need to have some formal financial qualifications. Currently, ACCION New York has put more importance in finding staff with clients knowledge and being able to talk the language of the clients rather than staff with financial background<sup>17</sup>. This however requires more training for the staff.

## Co-operation with formal financial sector

It was already described that ACCION New York co-operates with banks in the following areas:

- Refinance (63 banks)
- Cheque issuing to clients (CHASE Manhattan)
- Instalments payment by clients (CHASE Manhattan)

In addition, potential schemes to get more referrals of clients by banks are analysed. However, the biggest obstacle seems to be that most potential clients of the program do not use banks at all or do not get to the point of discussing a loan appraisal with a bank loan officer who could refer them.

## Non-financial services such as Business Advisory Services (BAS)

There are no general support schemes undertaken by ACCION New York apart from a general job descriptions of the loan officers who should be able to help the clients being aware of financial trouble ahead of time and being able giving advice for improvement.

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<sup>17</sup> for example, the former jobs of two loan officer – which the research team evaluated as very efficient in their jobs, have been supermarket cashier (2x) and some work for a credit collection agency

## Benchmarking case study<sup>1</sup>

### ADIE, Paris France

(Association pour le droit à l'initiative Economique)

Date of visit: January 10-11, 1999

Executed by: Jan Evers, Klaus Svanholm Nielsen

### Objectives and vision

ADIE is an association founded in 1988. The inspiration for which came from Grameen Bank in Bangladesh<sup>2</sup>. ADIE, or the people behind it, wanted to create a micro-lender in France to help individuals excluded from economic activity. It is important to bear in mind that ADIE see itself at least as much as a social organisation as a economic sustainability as a short time prime goal.

#### *Mission*

- To help excluded individuals to start their own firms
- To provide loans to non-bankable people and to make them bankable

ADIE has two main instruments:

- Supply of micro-loans with a low rate of interest (6,5% for all loans + 3% initial fee<sup>3</sup>) and
- intensive support programmes to ensure a high rate of survival of the financed new-starters.

ADIE wants to continue to grow rapidly. According to ADIE the number of loans is expected to increase from 1800 in 1998, to 2400 in 1999, to 6000 in the year of 2001 and to more than 10.000 per year later on. In 1999, ADIE wants to implement a programme of peer lending. By the year 2001 about 1000 out of the 6000 loans are expected to be peer loans. In 1995 the number of loans was only 700.

More people will be employed to deal with this expected expansion and productivity is planned to increase by 30%, from 32 loans per year per loan officers to 42<sup>4</sup>, in the coming years.

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<sup>1</sup> This case study was sent as a draft to ADIE in April 1999, checked by the management and revised in June 1999 in accordance with their comments. It is, therefore, an externally evaluated case study which has been accepted by the management of the organisation.

<sup>2</sup> Presentation publication by ADIE

<sup>3</sup> All loans pay 6,5% interest rate. According to French law – usury prevention - the rate of interest rate at the time of this study must not exceed 11% p.a. included al cost and fees for the client

<sup>4</sup> Credit Solidaire 2001 - Plan Triennal de l' ADIE, October 1998

## Short history

ADIE was created in 1988 and unlike other organisations, e.g. Fundusz Micro in Poland - ADIE had no start-up capital. The association was, and is still, forced to raise capital to finance its lending activities and to cover its costs.

According to the legal framework in France (as in many other European countries such as Germany and Spain) loans can only be issued by organisations which have the legal status of a bank. ADIE received authorisation from the "*Comité de la Réglementation Bancaire*"<sup>5</sup> which allows them to make loans from equity. However, ADIE expanded its lending activities faster than it could increase its equity and, therefore, needed extra loan funds.

In 1994 ADIE started to make partnership agreements with banks to solve this problem. They currently have agreements with twenty-five banks. Under these agreements, the bank issues the loan after ADIE undertakes a positive credit worthiness evaluation. The bank receives the 6% interest and a 70% guarantee from ADIE. ADIE receives the 3% initial fee. In 1998 the banks managed 75% of all ADIE's loans, and the remaining 25% stayed within ADIE's own loan portfolio.

These partnerships have enabled rapid growth, from 851 active loans per year in 1996, to 1299 in 1997, and 1600 in 1998. In that time the number of people employed by ADIE increased from 30 to 85.

## Organisational structure

ADIE has 14 branches (delegations) covering most of France. According to ADIE's business plan – "*Credit Solidaire 2001*" - the whole France will be covered in the near future and the number of branches will be increased. The structure is clearly decentralised and all loan decisions are made by regional delegations. There are quarterly meetings of the regional branch managers.

Each delegation has a regional manager and a number of loan officers as well as a credit committee. According to *Credit Solidaire* the numbers of agents de credit was in 1998 24, the numbers of charge de mission (the highest ranged of the two) 32, in total 56 persons.

In addition, ADIE "employs" 300 volunteers - often retired professionals – mainly to support clients in areas too time consuming to be covered by the loan officer and to participate in the credit committee.

After one year training period, one loan officer is responsible for 70-80 active clients<sup>6</sup>. They are currently attempting to raise this number in order to increase efficiency.<sup>7</sup> A loan officer typically conducts 300 client interviews per year, resulting in 40 new loans. He is also in charge of the follow up of the client.

The committee of credit approves all loans in the region. The committee normally meets several times a month. The members of the credit committee are volunteers - e.g. former professionals, such as bankers, lawyers and managers. In the region of

<sup>5</sup> see letter of them to Ms. Nowak, dated 18.02.1991

<sup>6</sup> According to Eric Mezieres, in charge of ADIE research, interviewed 12.01.1999

<sup>7</sup> According to Sophie Chabanel, regional manager in Ile de France, interviewed 11.01.1999

Ile de France, 5 to 10 loans are approved per weekly meeting<sup>8</sup>. Before approval a loan officer presents the loan application to the committee. The client does not participate.

## Target group and clients profile

One of ADIE's main client groups consists of persons on RMI<sup>9</sup>. In 1997 44% of borrowers were on RMI: 27% were long-term unemployed; the other were under short term unemployment<sup>10</sup>. ADIE wants to help all vulnerable groups, such as persons coming out of prison, women in rural areas, young people from disadvantaged areas as "*Bonlieue*" and gypsies. Summarised this means that ADIE wants to make the poorest of the poor bankable.

Because most of ADIE's clients are receiving social benefits ADIE has to constantly adjust its procedures because of legal and social changes imposed by the French authorities. According to Maria Nowack, president of ADIE<sup>11</sup>, one of the main task for ADIE is simply to follow and adjust to new laws and rules.

## Some key-figures for ADIE

1.	Number of loans disbursed since inception	5.422 <sup>12</sup>
2.	Amount of loans disbursed since inception	FF 108.500.000
3.	Average loan amount	FF 22.000 <sup>13</sup>
4.	Average loan term in months	20 months <sup>14</sup>
5.	No of employees	80
6.	loans distributed in 1998 <sup>15</sup>	1629
	Active borrowers	3300 <sup>16</sup>
7.	Loan amount handed out/ issued in 1998	FF 28.000.000
8.	Loan balance outstanding for 1998	FF 44.000.000 <sup>17</sup>

<sup>8</sup> see above

<sup>9</sup> Social welfare received by non-assured unemployed persons. In 1997 the ACCRE was suppressed leading to a decline in the loan demand for this group.

<sup>10</sup> ADIE - Rapport d'activité 1997

<sup>11</sup> Interview the 11.01.1999

<sup>12</sup> figure results from database research 12.02.1999

<sup>13</sup> Maximum loan size = F.fr. 30.000

<sup>14</sup> maximum 24 month

<sup>15</sup> for 1996: 851, for 1997: 1279

<sup>16</sup> number given by ADIE (Bruno Gaultier) for the end of 1998

<sup>17</sup> 25% are loans issued by ADIE itself, 75% by its bank partners but guaranteed by ADIE

9.	Administrative expenditure for 1998	FF 22.000.000
10.	Write offs for 1998	1% <sup>18</sup>
11.	Delinquency rate for 1998	6% <sup>19</sup>
11.	Income from clients in 1998	FF 1.800.000
12.	Re-financing costs	0
13.	Estimated rate of survived enterprises (after three years)	75% (after two years) <sup>20</sup>

Productivity <sup>21</sup>	32 <sup>22</sup>
Number of loan per loan officer, total	59

The figures on how ADIE's loans are served are based on calculations made by ADIE. The percentages indicate the expected situation for a loan in its whole lifetime. Please note that figures from banks, if publicly available, normally describe the situation for specific time frame e.g. end of financial year, ADIE's figures are not directly comparable with figures from credit institutions. (See below for more information on the distinction between loans from ADIE's own funds and guarantees to bank).

ADIE estimates that on average it needs 1.982 EURO (13.000 FF) to cover loan transaction costs and 305 EURO (2000 FF) to cover the risk (of that are for the packaged loans 30% taken in charge by the bank partners). The transaction costs can be divided into 4000 FF for transition (last interview, credit committee), 5000 for training and advice and 4000 FF for the development of the institution. The last cost factor will decrease because the institutional framework is developed. In addition, it has to be kept in mind that the costs for advice and support are correlated to the difficult environment for entrepreneurs in France.

<sup>18</sup> write offs since beginning: 3%

<sup>19</sup> since beginning: 10%

<sup>20</sup> from an evaluation study in 1998 with all loans from the beginning without loans of the last two years. In 1995 a study was undertaken with a survival rate of 66% after two years.

<sup>21</sup> Number of loans per year / number of loan officer loan officers = Charge de mission (CM) + Argent de Credit (ADC)

<sup>22</sup> According to the mentioned report "Credit Solidaire 2001", the productivity will increase to 42 or by 31%.

## Financial Services and credit delivery methodology

### Client recruitment

Like all micro-lenders ADIE get its clients through various channels.

Currently, the biggest proportion of clients come for most branches either by media attention or enterprise agencies. ADIE's experience suggests that people who respond to information in media are less serious and lead to fewer loans in comparison with other acquisition strategies.

Other clients come from social agencies and chambers of commerce and enterprise agencies<sup>23</sup>. ADIE's experience of clients from social agencies and chambers of commerce is mixed, because these people often have severe problems which the referring organisation "*just wanted to get rid of*".

One example of an effective instrument to target the market of unemployed is distributing flyers at the location where unemployed have to fill in forms for exoneration of social insurance.

### Current products and plans for future products

ADIE currently provides mainly one financial product: credit for investment and working capital, with a maximum amount of 30.000 FF and a loan period of two years. This loan is either issued by ADIE itself or by its bank partners. The conditions are similar.

In some regions ADIE issues grants and subsidies refinanced by the local government who rely on ADIE as an effective distributor. One other product are "*honour loans*": loans with equity character.

An interesting product is the borrowing of material: as ADIE discovered that many entrepreneurs need the same things for starting up (transport car, computer, market equipment), they start to recycle them of failed entrepreneurs and lend them out.

A group lending model is planned and is currently being piloted for client groups from similar social backgrounds or particular neighbourhoods (which, therefore, provides the basis for networking and group dynamics), in particular for gypsies, former prisoners and young people from the beanlieu.

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<sup>23</sup> It seems to be very different from region to region where clients come from. For example, in the inner-city area of Paris (branch Ile de France) it is estimated that 7% of clients are referred by social agents, 17% of chambers of commerce and enterprise agencies, 30% through media attention and the rest by "word of mouth". At the same time in a much smaller city like Strasbourg, more than 50% are referred by enterprise agencies. For the region Ile de France, very few clients are referred by banks in other areas co-operation works better.

## Credit delivery methodology

The loan procedure is again quite different from region to region. In the future, the job of an co-ordinator is implemented who visits branches regular to harmonise procedures and do an internal best practise exchange. However, a more or less typical loan procedure is as follows:

- a) The client gets information about ADIE
- b) The client contacts ADIE, normally by phone (served in some regions with high demand by volunteers)
- c) The client receives a form of 6 pages with detailed questions about income, rents, civil status, marriage, children, time of unemployment, project description etc. The file is sent back to ADIE.
- d) A loan officer interviews the client. To date, these interviews take around 2 hours per client
- e) The loan officer discusses the application with another loan officer in the delegation (branch). The names of the guarantors have to be settled. If the branch agrees the loan, the application goes to the Committee of Credit
- f) The loan officer presents the application to the committee
- g) The client is informed of the decision
- h) The loan is either from ADIE's own funds (25%) or a bank loan guaranteed by ADIE (75%). In both cases the client has to open a bank account
- i) The loan officer enters the client's file in the computer database
- j) If the loan is from ADIE's own funds the loan is paid out from the headquarter in Paris, transferred by a bank account
- k) If it is a bank-loan the client goes to the bank and signs a contract. The bank will pay out the loan into the account and repayments are sent directly to the bank by the client
- l) Normally the loan is available to the client within 15 days.
- m) Repayments start 2 month later.

According to ADIE an average application takes 4 hours before the approval of loan. The time used for direct banking activities is about 1 hour. But the most time-consuming element takes place after the approval. In average each client receives 15 hours of support in the following two years.

On average, the loan officer gets in touch with the client once per month to check their situation. The important objectives are a) to check if the client meets the administrative demands regularly (due to the high bureaucracy requests to entrepreneurs and b) to find out if they made or lost money in the previous month. This meeting have both a fire-fighting and a preventive support strategy.

Besides the direct support, ADIE organises entrepreneur circles where clients meet to exchange their experience and receive training. However, from region to region success rate of invitation varies between 1-30%.

### **Cost of services**

All loans cost 6% interest with a 3% initial fee. There are no membership fees.

### **Loan administration and MIS**

Once the loan officer enters the client's file into the computer database the loan can be monitored by ADIE's central administration. If the loan is from ADIE's own funds the client receives a specific instalment document. ADIE will normally instruct the client to repay the loan by using automatic payment systems through banks. If the loan is bank loan ADIE does not give this instruction and the client has to go to the bank and sign a loan contract.

All the branches are connected electronically to the headquarter in Paris. Any changes to loans e.g. delays or rescheduling must be registered in the central computer system. The loans issued by bank partners are also registered in this database

### **Risk management**

#### **Credit worthiness assessment**

Decisions on credit worthiness are based on

- the business idea
- the client's personal background
- and the projected cash-flow.

In the telephone interview, the loan formula is applied and these criteria will be assessed prior to the interview with the loan officer. Typically, the business will be visited. During the telephone interview it is made clear to potential clients, that the formula is not for selection but for general understanding of the idea. In general, the interview style is a "*teaching approach*"<sup>24</sup>

Finally the loan officer decides if the application is strong enough to be evaluated by the credit committee and the branch manager has to co-sign. At that stage the loan application is decided by the committee of Credit.

The following gives an impression of the selection system. Of 100 initial enquiries about 9 people will receive a loan.

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<sup>24</sup> According to Chabanel, see above; "we make sure that they understand what we are doing and what we are looking for".

Clients call (100 persons) → ADIE send a file to clients (40 persons) → clients send the file back to ADIE (30 persons) → personal Interview (28 persons) → branch approves loan (10 persons) → Committee of Credit approve loan (9 persons)

To increase the quality of loans ADIE is careful with lending to people who want to start businesses in very difficult and competitive sectors, such as market-selling and imports and exports.

### Ensuring payment

Payment control is done by the central office in Paris where one person checks late payment and regularly provides branch managers with an e-mailed list of all late payments. These are followed up by loan officers.

If a payment is 5 days late, the client gets a letter and a telephone call. If a loan is delayed by two instalments in succession, or three delays in total, the loan is registered under a specific item in the main system. If one or two instalment are late the loan will normally just be prolonged and no specific action will be taken.

Repayments are discussed in regular meetings between the branch manager and each loan officer. If further action seems appropriate, the responsibility moves from the loan officer to an internal repayment officer. The guarantors are involved as a last resort to put pressure on the client.

According to a branch manager, the repayment system "*is not very formal but very reactive*".<sup>25</sup> However, there is no punishment for late payment and for the loans issued by bank partners, information about late payments can be deferred by one month due to bank practices (there is not always a separation between ADIE clients and automatic late payment listing).<sup>26</sup>

ADIE demands that the client sends some kind of a monthly report. According to ADIE these reports have a positive impact on the ability to catch potential defaults in an early stage.

### Covering losses (collateral or security)

In order to reduce risk each client has to name up to 5 persons who will guarantee 50% of the loan. The function of the guarantors is to create a "*pressure*" or circle of responsibility around the client. Only in very few cases does ADIE actually call on guarantors, because the cost will always exceed the value of the guarantees.

ADIE does not use ordinary private collateral, such as houses, cars. They do, however, take trucks and lorries financed by ADIE as guarantees. Personal guarantees are not used because all loans are personal loans with no limited responsibility. It is however very rare that ADIE uses this option.

<sup>25</sup> et cit.

<sup>26</sup> According to Mezieres, see above

## Source of funding and financial sustainability

In 1994 ADIE made its first agreement with the bank sector. As mentioned above this agreement has made it possible for ADIE to expand its activities very rapidly. However, the agreement has probably not improved its financial self-sustainability. The bank-loan does not affect ADIE's liquidity but for this facility, *ADIE pays relatively high funding costs*, because the bank receives all the interest payment (6,5%) from the clients. Furthermore, ADIE must guarantee 70% of the loans. The agreement between ADIE and the banks ensures ADIE a start fee of 3%. For 1200 loans in 1998 (75% of 1600) on average FF 22.000 this creates an income of around FF 0,8 million.

25% of ADIE's loans are made from their own loan funds. ADIE generates 6,5% income from interest and 3% fees on these loans. For 400 loans with the average size of 22.000 FF this would make 0,83 million FF (regardless the bad debts around 10%).

Even if ADIE receives all the interest paid, the gross income can be estimated at 1,7 million FF. This level of income can not cover operational costs of more than FF 20 million in 1998 but it would cover the bad debts (estimated at 2,52 million FF<sup>27</sup>). (It has to be mentioned that precise figures on income are not directly available from ADIE's publications).

Using Elisabeth Rhyne's terminology, ADIE should be classified as an institute of level one of financial self-sufficiency. "*Revenue falls short of operating expenses, resulting in a continuing need for grants*"<sup>28</sup>. ADIE openly admits that economic self-sustainability can not be reached under the French interest rate law and other difficulties created by the business environment.

It is, therefore, important for ADIE to ensure a continued flow of new subsidies. In 1998 ADIE got FF 5,8 million from the EU, subsidies from the French State were F.fr. 6,6 million. Finally, the local authorities gave F.fr. 6,9 million. In total F.fr. 19,3 million<sup>29</sup>.

In addition to funds from public authorities ADIE also receives funds from a large numbers of other organisations. According to ADIE the work involved in keeping all the 250 funding partners<sup>30</sup> happy is substantial.

<sup>27</sup> 10% of the value of own loans of 8,8 million FF (400\*22.000FF) makes 0,88 million FF and for the 10% bad debts in the 70% guarantees to the bank loans worth around 26,4 million FF this would be 1,84 million FF.

<sup>28</sup> Otero, M/ Rhyne, E.: *The New World of Microenterprise Finance – Building Healthy Financial Institutions for the Poor*, Kumarian Press, West Hartford, page 18

<sup>29</sup> Figures are from Credit solidaire 2001

<sup>30</sup> According to Maria Nowack, the president of ADIE interviewed at the 11.01.1999

## Benchmarking case study

# FINNVERA

Helsinki Finland

*Date of visit:<sup>1</sup> February 18-19, 1999*

*Executed by: Jan Evers, Klaus Svanholm Nielsen*

### Objectives and vision

KERA (now part of FINNVERA) was founded in 1971 by the Finnish state. Initially, KERA<sup>2</sup> acted as an instrument to promote economic progress in the less developed parts of Finland<sup>3</sup>. Later on, their activities were expanded to include the whole nation. Today FINNVERA is an integrated and important player in the financial market in Finland and is well known nation-wide. FINNVERA is one of the four main suppliers of financial bank-capital to micro-enterprises in Finland. On January 1<sup>st</sup> 1999 FINNVERA was created by merging KERA, the Finnish Guarantee Board<sup>4</sup> and some other public financial organisations into one company.

FINNVERA operates as a "niche" bank (without being a bank – see below) by providing loans to two main groups:

- new firms and SMEs<sup>5</sup>,
- selected groups, such as women- or micro entrepreneurs.

As FINNVERA distributes different products (loans, guarantees, venture capital) to a range of different types of clients (micro-enterprises, start ups, SME) the study focuses on FINNVERA's lending activities related to micro-enterprises<sup>6</sup>. These programmes were provided only by KERA and, consequently, this report refers to KERA in relation to all of these activities in the years prior to 1999.

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<sup>1</sup> Apart from information sources quoted, the basis for this case study is the visit and the presentations of and interviews with Mr. Jukka Vilppo (Director Small Enterprises), Ms. Eeva Siurua (Business Analyst in Oulu), Ms. Anneli Soppi (Development Manager) and Mr. Esko Elo (Regional Director) and interviews with two of FINNVERA's clients.

<sup>2</sup> ALMI in Sweden and SND in Norway operate very much in the same way as KERA

<sup>3</sup> Because of Finland's size and geography (same size as the united Germany, but with only 5 million inhabitants) regional aspects play a central role in Finnish politics and administration

<sup>4</sup> Which also include the Export guarantee Board

<sup>5</sup> Small and medium sized firms with less than 250 employees, turnover of Euro million 40 and assets of Euro million 27

<sup>6</sup> KERA has a specific loan category called micro-lending, delivered to all business with max 5 employees (annual report 1997, page 2) with a special target programme for women. This definition of micro-lending does not correspond completely to the benchmarking project where we define a loan ceiling up to EURO 25,000 for businesses with less than 3 employees in the first years of business.

Micro- or women entrepreneurs receive between 15-20% of all new loans measured in euros, and more than 50% when measured in numbers.

FINNVERA operates in the financial market as a big nation-wide bank and has established a working style which, to a large extent, is similar to the banking sector. However, FINNVERA does not want (and is not allowed by the owner, the Finnish state) to compete with the private banking sector.

## Short history

After it was founded in 1971, KERA became a nation-wide operation at the end of the 1980's. At that time the Finnish economy was experiencing dramatic changes.

Finland was at that time quite dependent on exports to the Soviet Union. The collapse of this market, combined with a sharp drop in domestic activity, especially in the construction sector, created a dramatic economic crisis in Finland from 1990 to 1994. Most of the banking system went bankrupt and the Finnish state was, as in Sweden and Norway, forced to support the financial sector with large capital inflows<sup>7</sup>. KERA was also affected by the crisis and reported losses. The unemployment rate is still high - around 12% - compared with less than 5% back in the 1980's, but the economic climate is slowly improving.

As a result of the banking crisis the potential conflict between KERA and the banking sector disappeared for a period and KERA could increase its activities in the first half of 1990s. Improvements in the economic situation has, once again, reinforced the potential conflict.

As a result FINNVERA has moved its market "downward". In 1996 a new type of loan, called "micro-loan" was introduced. In 1997 KERA introduced "*Loans for women entrepreneurs*". Around 25% of all new-starters in 1997 were using KERA although there were strong regional differences (e.g. 80% in Oulu and 20% in Helsinki).

The organisation receives three types of state subsidy for lending to SME's (for calculation of that benefit see chapter 1.9):

- Access to cheap refinance (due to a high credit worthiness with the state as a "*guarantor of last resort*")
- 50% coverage of bad debts
- interest subsidy for special loan programmes, - in particular the ones important for this study: loans to micro-enterprises and women entrepreneurs.
- KERA was lending two billion euros in 1997. Approximately 50% of these loans were classified as loans with low subsidies receiving only marginal public subsidy. The rest received more substantial subsidy, mainly in form of reduced rates of interest.

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<sup>7</sup> According to OECD (June, 1998 p. 29) non-performing loans in the banking sector rose to 9,3 % in 1992. The expected final loss is estimated to Fmk billion 45 (10% of 1993 GDP)

In 1995 Finland joined the European Union. This has not changed the overall framework for KERA/FINNVERA and is unlikely to change anything in the coming years.

## Organisational structure

FINNVERA is a conglomerate of several companies and funds. It deals with many kinds of publicly subsidised financial activities, such as lending to SMEs, state guarantees schemes, venture capital. Furthermore, FINNVERA also provides legal commercial services through a sub-company.

FINNVERA employs 400 people, nearly all full-time employed. The majority are employed in the 15 regional branches, some of them are located in the same office buildings as state support agencies.

FINNVERA is not supervised by the Finish bank authorities and, consequently, is not obliged to follow the European banking rules, the CAD-rules. However, FINNVERA does calculate a capital adequacy ratio (19.1%) and observes the rules of bookkeeping on defaulting debts etc. laid down by the supervision authorities.

The lending activity (in the former KERA) is done by the 15 regional branches. Each branch has a manager and 10-15 employees. In the example of Turku (a city with 440.000 inhabitants), the branch consists of the regional director and thirteen staff. Eight of these employees are loan officer ("business analysts"), four of whom make up the back office ("financing secretaries") and one person manages the office and represents the branch to telephone callers and visitors. This means that 60-70% of staff are active in lending – a high ratio compared with conventional banking.

The structure of decision making for micro-loans is simple. If a loan is approved by a loan-officer, the branch manager has to confirm the loan. Each loan officer approves about 75 loans per year (used as a measurement of organisational productivity) and has around 200 active loans in his portfolio to manage.

It is important to understand, that the same loan officers manage all lending products to the different client groups: from micros with no employees to medium size enterprises with 250 employees. "*We wear different hats all the time*", says one loan officer. This makes a comparison in productivity with other micro-lenders nearly impossible.

FINNVERA does not use volunteers. The entire staff is paid on almost the same salary level, with a small spread from the top to the bottom of the wage hierarchy compared to the UK or central Europe. According to the annual report the average annual wage is FmK 200,000 (Euro 33,000), only marginally lower than salaries in the private banking sector.

## Target Group and client profiles

FINNVERA has more than 20,000 clients. 82% of these are firms with less than 5 employees. According to EU classification 99% of all clients are SMEs. The average size of all loans are FmK 370,000 (Euro 63,000) while the micro-loans range from 3,300-16,000 Euro with an average of 12-13,000 Euro.

In 1997 more than half of all the 17.000 new loans were distributed to either micro-enterprises or women entrepreneurs. The size varies from industry to industry. The biggest loans are made in manufacturing and the smallest are given to entrepreneurs in private and business services.

The biggest sectors for micro loans in 1998 have been industry (31%), business services (17%), consumer services (14%), transportation (11%), retail (12%), and accommodation and catering (7%). Loans for women peak at consumer services (27%), retail (25%), business services (18%) and accommodation and catering (12%). Women consumer services consist mainly of beauty services and outsourcing of health care activities.

KERA<sup>8</sup> find it problematic that women-entrepreneurs tend to focus on traditional services, such as cleaning, retail, home-production of clothes and arts and crafts and are reluctant to start businesses in manufacturing. These traditional industries contain harsh competition and little potential for business growth.

Around half of all micro and women-lenders start business from home. The percentage is higher for women and people working in the service industry, and lower for men and people working in manufacturing.

KERA's client profile is similar to other micro-lenders: over 50% are home-based and involve marginal activities such as pottery, home made candles for gift shops, framing pictures, sewing for friends, running gift shops and cleaning. However, when asked about the most marginal business for loan disbursement the loan officers identified the above examples as the most marginal (expressing doubts whether lending to them made sense) while the US micro-lenders, in particular, saw them as the more typical client group.

Therefore, FINNVERA's micro-lending activities do reach marginal businesses which are some way away from being bankable (and – seen in traditional terms – from being profitable). The average client group, however, is much more upmarket, even if still unbankable. This different client focus is likely to be the result of a stronger social welfare system, and a different national economic basis (less service and self-employed oriented) but also a client recruitment system which is based more on referrals from mainstream banks.

KERA does not focus on ethnic, or educational background, and there are no statistics on client proportions. Having an income below the poverty line or being from a minority ethnic background are not big issues in KERA nor Finland in general<sup>9</sup>

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<sup>8</sup> Eeva Siurua, business analyst in Oulu and Anneli Soppi, business analyst in Tampere

<sup>9</sup> Finland has one of the lowest immigration populations in the EU and has traditionally faced emigration to e.g. Sweden

## Credit portfolio by industry December 31, 1997

Industry:	All loans	Women-loans	Micro-loans
<i>Total manufacturing</i>	68%	12%	31%
<i>Total service industries</i>	30%	87%	65%

Source: Annual report 1997 and special data from FINNVERA

## Facts and figures about KERA

		Micro-lending activities in 1998 (1997):	All lending activities 1997 (1996):
1.	Number of loans disbursed since inception	< 8000 <sup>10</sup>	
2.	Amount of loans disbursed since inception	Euro 47 mill. <sup>11</sup>	
3.	Average loan amount	Euro 12-13,000	Euro 62,000
4.	Average loan term in months	60	
5.	No of employees	n.a. (->)	285
6.	disbursed loans in 1998	3711 (5506)	
	Active borrowers <sup>12</sup>	(8,694) <sup>13</sup>	
7.	Loan amount of active borrowers	n.a.	n.a.
8.	Loan balance outstanding for 1998	Euro 138,2 mill. <sup>14</sup>	Euro 1 Billion
9.	Administrative expenditure	n.a.	1997: Euro million 20,5
10.	Credit losses	<2% <sup>15</sup>	1997: 2% <sup>16</sup> (5%)
11.	Delinquency rate	9%	
11.	Income from clients		1997: Euro million 71,8
12.	Re-financing costs (average)	n.a.	n.a.
13.	Estimated rate of survived enterprises (after three years)		85%

Source: Annual report 1997 and special data from FINNVERA

<sup>10</sup> in 1998 (1997), 2450 (3945) from micro-loans and 1261 (1561) from special loans to women

<sup>11</sup> according to the presentation during our visit per 31.12.1998: 83,9 and 197,9 million FmK

One Euro = 5,94573 FmK (figures are sometimes rounded)

<sup>12</sup> new clients/ new loans disbursed in 1998 (1997): 3.669 (5506) according to questionnaire filled out by Eeva Siurua, January 1999

<sup>13</sup> annual report 1997, page 5: "In 1997, Kera had a total of 8694 microloan customers"

<sup>14</sup> FIM 649 million for micro-loans and 173 million for special loans to women

<sup>15</sup> 2,4% for micro-loans and < 1% for women loans. However, due to the fact that the program is quite new and losses are given with a 1 year grace period, this figure has to be expected to increase

<sup>16</sup> The default rate is low for the moment because of a generally positive economic climate, furthermore many new loans have been provided to micro-enterprises and women in the last two years. FINNVERA believes that the long term default rate is around 5%. FINNVERA follows the rules according to financial supervision and measures the amount of bad debts on a group basis - not individually.

## Other Figures

	Micro-lending activities in 1998 (1997):	All lending activities 1997 (1996):
Number of clients	n.a.	23,000
Average size (employees)	n.a.	5,2
Average size (turn-over)	n.a.	Euro million 1,1
Rejection rate	50% (30%)	n.a.
Productivity <sup>17</sup>	n.a.	75

Source: Annual report 1997 and special data from FINNVERA

According to the above figures KERA's lending activity has been decreasing for micro- and women entrepreneurs. The reason is that the loan activity was extraordinary high in 1997 when micro-loans and loans for women entrepreneurs were introduced. In 1997, 21% of loans were directed to micro and women entrepreneurs. The remaining 79% went to SMEs.

## Financial services and credit delivery methodology

FINNVERA offers different types of loans. The most interesting types - in the light of benchmarking of micro-lending - are the "micro-loan" and the special loans to women entrepreneurs. These are the loans we are focussing on in this study.

### Client recruitment

Compared with other micro-lenders, FINNVERA is well known by the public on a national basis. Their branches are normally located on "*the first floor*" and FINNVERA does not present itself as an ordinary bank.

FINNVERA estimates that 25% of all clients are sent to FINNVERA after having been in contact with the ordinary banking system. FINNVERA considers this connection to the banking system to be essential. The relationship between FINNVERA and the banks is often based on personal relationships, especially in the smaller towns in the rural part of Finland (outside Helsinki). FINNVERA encourages its employees to establish and develop personal relationships with bankers.

However, since implementing the scheme in April 1997 the demand for loans has been so high that KERA did not have to develop a structured client-acquisition strategy. They were simply overrun with demand, mainly due to raised awareness through media attention and word-of-mouth. A more active marketing approach is planned in the coming month.

<sup>17</sup> Productivity is measured as numbers of new loans per year per loan-officer

## Credit delivery methodology

All decisions regarding micro-loans and smaller loans are handled by one loan officer and the branch manager, who approves all loans. It is worth knowing that FINNVERA does not use the term "loan-officer". They operate with business analysts and development managers. This indicates a strong industry orientation in the organisation. Each business analyst has a special area e.g. wood-processing or private business services for women. When a client contacts a branch he or she will be served by an expert in the relevant market.

Steps in the loan process:

- a) **Application:** The applicant will have to fill in a loan-scheme, containing information about business plans, e.g. market description, prices, names of competitors, calculation of cost, personal experience in the industry. The applicant also has to give information about his or her private economic situation, e.g. rents, income, family, children, tax, so it is possible to construct a budget for both the firm and the applicant personally.

FINNVERA does not expect a full scale business plan for micro loans, but some indication of marketing, competition and financial planning. However, if a client needs assistance FINNVERA refers them to the "*state business service centres*", organisations acting on behalf of the Ministry of Labour and the Ministry of Trade and Industry. Many of the branches of FINNVERA are located in the same building as these service centres. The centres provide a free two day consultation service to start-up businesses.

General guidelines for application approval are: businesses employing 1-5 people with an entrepreneur working full-time in the business.

- b) **Meeting:** The second step in the loan application is a personal meeting between a business analyst or development manager, normally at the applicant's business. Here the applicants objectives and plans are checked.
- c) **Analysis:** After this interview the loan officer produces a decision report. FINNVERA has five different schemes dependent on the size and nature of the application. For micro-enterprise and new-starters FINNVERA uses the same and most simple scheme. FINNVERA always checks the applicant's credit record at a nation-wide bureau. If there are unpaid debts or bills, the loan will normally not be approved.

The criteria for approval are based on the profitability, the company's development potential and the personality and character traits of the entrepreneur.

- d) **Decision:** The final approval is done by the branch manager. He or she will normally spend 5 minutes on each application and normally the pre-decision will be followed. This step is important because it gives the manager a chance to control the work of the loan officers. It also reduces the risk of nepotism or bribery (probably not a real risk in the case of micro-lending in Finland). Furthermore, it means that the manager shares responsibility for the risk of default.

- e) **Follow-up:** Each year FINNVERA receives a financial statement from the client's tax officer. In addition, clients are asked to fill out an annual report (from which he receives feedback, including computerised ratios with industry comparisons from FINNVERA's own customer basis). Both reports are the basis for checking the soundness of the client and the need for intervention. Apart from that, there is no general follow up policy.

According to FINNVERA<sup>18</sup> the cost (in time) of handling small loans are substantially smaller than the time spend on bigger loan application. For bigger SME-loans FINNVERA sometimes has to negotiate with banks and, consequently, spends much more time.

If the effort for one loan decision is measured in time units, we estimate the following: normally a micro-loan is decided after a 1-2 hours site visit, a ½ hours analysis work by the loan officer, and 5 minutes of the regional manager's time, plus the transport time for the loan officer. For the loan officer it is, of course, important that he or she organises the client-visit efficiently.

As quoted above: in 1998 it is estimated that every second application was approved for a loan.

The main differences between KERAs lending approach and that of the banks' in relation to their delivery methodology were:

- They do not use guarantees, the focus on profitability and development potential is not disrupted by security aspects<sup>19</sup>
- They specialise in delivering only SME finance
- The recruitment strategy and training for FINNVERA employees focuses on company financing and on qualifying for various aspects of banking business.
- Site visits: loan officers go to the client's business place and this is seen as the heart of the credit worthiness evaluation process<sup>20</sup>
- Learning approach: the loan officers' industry specialisation and the construction of a specialised SME industry database with each client means that there is an ongoing learning process about relevant markets.
- Crisis approach: due to a lack of collateral they take a very active approach in crisis situations: once they have assessed the chances for turnaround they put a rescue strategy in place if it seems likely to be successful (further details on this subject are lacking in our study)

<sup>18</sup> Mr. Elo, Regional Manager in Turku (Åbo)

<sup>19</sup> Mr Elo: "Looking to collateral disturbs the concentration on the main thing: sustainability and profitability of the business idea".

<sup>20</sup> The following detail is interesting: This feature is often used by the loan officers in the banks if clients later on apply for a loan in the bank. The loan officer in the bank makes contact with the loan officer in FINNVERA to get more personal information about the client as the banks do not visit their small clients and consequently the banks have a weaker knowledge of the client and the market.

- Atmosphere with customers: friendly not distant atmosphere<sup>21</sup>
- 

### **Cost and terms of service (fees and interest rate)**

The interest rate FINNVERA charges of clients is fairly low. It varies from 3.2% to more than 7% ( EURIBOR 3.2% (Jan. 99)+ spread (0,5% for women loans and 1% for micro loans). The lowest rate is paid by disadvantaged clients – as micro credits - in less developed areas.

It is important to note that FINNVERA does not ask clients for any kind of risk-premium on small and/or risky loans. (However, as described later a risk-premium is calculated and charged to the state.) On the contrary micro-loans and loans to entrepreneurs are the cheapest, because of government subsidies.

The terms of a micro-loan or a loan to women entrepreneurs are as follows:

- Maturity is 5 years with a one year grace period
- Biannual repayments
- Interest rate is 6-month EURIBOR (3.2% Jan. 99) without margin for women entrepreneurs and with a margin of ½% for micro-loans
- A front fee of 2% or minimum Euro 50 at the first disbursement
- The loan amount is between Euro 3.360- 16.800
- No collateral usually except for a personal security by the entrepreneur in the case of a limited company as a beneficiary (20% of the loan amount)

### **Loan administration**

All loans are administered by a central unit inside FINNVERA. The system provides the loan officers and the managers with information about the loan-portfolio and default rates and so on. The administration of loans seems to be similar to the systems used in the banking industry apart from not delivering personal bank accounts to handle repayments.

We have not investigated the database and MIS of FINNVERA so far.

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<sup>21</sup> as one loan officer said: "we see us more in one boat while bankers are much more distant" ... "we sit at their kitchen table in their home-based business and discuss the business serious as any corporate client ... – they are still a company for us"

## Risk management

### Credit worthiness assessment

As mentioned above, the loan officer will always contact a nation-wide credit bureau before approving any loans. Moreover the loan officer controls the personal budget plan and the business plans made by the applicants. Furthermore, the loan officer visits the entrepreneur at his or her home/business premises. According to FINNVERA only 50% of all loan applications are approved.

In the files about the clients FINNVERA uses a scheme based on the following assessments with five grades in different aspects:

	- -	-	0	+	++
Entrepreneurship					
Idea of product					
Competition					

Furthermore, FINNVERA separates clients into five risk groups: **A;B1;B2,B3,C**

Clients are also divided by geography: **I,II,III**. Group III is located in the most remote regions.

FINNVERA's assessment pays strict attention to the specific conditions in the different industries – supported by a in-house database. This is, of course, more important for bigger loans than for micro loans and loans to women entrepreneurs.<sup>22</sup>

### Ensuring payment and debt recovery

Every month the central loan administration system reports delayed repayments. After two weeks FINNVERA sends the first letter to the borrower. If he or she does not react to the first letter, letter number two will be sent two weeks later. If that does not help FINNVERA will take legal action against the debtor.

FINNVERA does not normally take cases all the way through the legal system because of the high cost. They view these procedures as necessary to avoid moral hazard from the clients. If FINNVERA feels that the clients are being unfair or trying to cheat, full legal action will be taken.

Non-served debts will also be reported to a credit reference bureau. According to FINNVERA most borrowers with delays contact FINNVERA before legal action is taken. Often FINNVERA and the troubled entrepreneur make an agreement and postpone the missing instalment by prolonging the loan.

<sup>22</sup> FINNVERA is a public organisation and consequently the client can and does complain about decision made by the loan officers. However, it is seldom that a decision is changed, but it shows that FINNVERA is not considered to be a 100% market-orientated organisation by the clients and the public in general.

Every year FINNVERA receives annual reports from all clients from the tax authorities. Furthermore, all FINNVERA's clients have to complete and send an annual report to FINNVERA. On the basis of these reports FINNVERA gives feedback to all their clients on industry development and how they compare with their competitors.

### Covering losses

FINNVERA has a special arrangement with the Finnish state. The state has guaranteed 50% of all loans. In 1997 KERA received nearly Euro 10 million in credit compensation from the state. FINNVERA does not use and is not allowed, according to governmental regulations, to use normal collateral, such as real estate. The reason for this limitation is a desire by the Finnish state to avoid direct competition between FINNVERA and the banks. According to FINNVERA this restriction can also be advantageous because it focuses the loan officers' attention on the entrepreneur and his project rather than on collateral.

### Source of funding and operational and financial sustainability

In 1997 KERA Corporation's main income sources were the following<sup>23</sup>:

Sources of income	In million FmK	In million Euro
Income from clients (interest and fees charged from clients) <sup>24</sup>	385,6 + 41,2	71,8
Interest rate subsidy of the state	197,4	33,2
State compensating credit losses	53,0	8,91

This stood against administrative expenditures of FmK 122,9 million (Euro million 20,5), real financing costs (interest expenses) of FmK 278,8 million (Euro million 46,9) and credit losses of FmK 132,7 million (Euro million 22).

To two different approaches are used to measure sustainability through lending activity:

- a) Spread-needed ratio:** The loss on bad debts in 1997 was FmK million 132,7 equal to 2.1% of the all outstanding loans and guarantees<sup>25</sup>. KERA's

<sup>23</sup> One Euro = 5,94573 FmK (figures are sometimes rounded)

<sup>24</sup> Income from interest was found on page 17 of the 1997 annual report under "public and public sector entities" (unfortunately, there is a translation mistake according to our interview partners), income from fees under "commission income".

administrative expenditure was FmK million 122,9 (Euro million 20,5) equal to 1.9%. **This means that an interest spread of 4% between refinance costs would be needed to be self sustainable.**

#### b) Income against expenditure ratios:

**Operational sustainability**<sup>26</sup> (= 385,6+41,2/ 278,8+132,7 +122,9) = 80%

**Financial sustainability**<sup>27</sup> (= 385,6+41,2/ 278,8+132,7+122,9+ 85) = 69%

There are two important limitations on all that figures:

1. These calculations cover the whole of KERAs operations. If the degree of sustainability could be calculated for micro-loans and loans for women entrepreneurs alone the percentage of sustainability would be much lower, the interest spread would need to be much higher. According to KERA the larger loans in the loan portfolio are profitable. The borderline between small and unprofitable loans and the bigger and profitable loans is maybe around Euro 30,000. More detailed numbers for micros are not available at the moment.<sup>28</sup>
2. A precise figure of sustainability would only be measurable if loan officers' workloads were identified to client sizes. This is probably not possible and in a way would be not precise either because part of KERAs/ FINNVERAs efficiency is financing different sizes in SME and making use of synergies in different market segments.

### Co-operation with formal banking sector

FINNVERA is one of the main players in the market for financing SMEs and micro-entrepreneurs in Finland.<sup>29</sup> The banking sector in Finland watches FINNVERA's operations carefully and will try to stop any move in a more commercial direction. FINNVERA 's precise market position is determined by a complicated political

<sup>25</sup> See annual report 1997, page 18, "claims on the public and public sector entities" of FmK 6303,6 million. However, it has to be kept in mind that this figure is not fully correct for our intention: we would need the average outstanding portfolio over the year and not the amount at the end of the financial year.

<sup>26</sup> calculated in the following way: Operational sustainability = income from clients / (re-financing costs + credit losses + administrative expenses)

<sup>27</sup> calculated in the following way: financial sustainability = income from clients / (re-financing costs + credit losses + administrative expenses + cost of own fund). Including the "cost of own fund" tries to inbound the opportunity cost for the equity capital of own capital. For our study we calculate this with an interest rate the double of the prime lending rate (in Finland this was near to 3,5% in February 1999). For the equity capital of Kera in 1997 FmK million 1,213 (page 19 annual report) this leads to costs of FmK 85 million. However, it has to be kept in mind that a more precise method to calculate opportunity cost would be the average ROE (return on equity) of similar operations, which is probably much higher than the double of the base rate. However, it could be argued that many banks on average make losses with their small firm lending business and therefore the average ROE could be also estimated on 0%.

<sup>28</sup> With the annual report of 1998 a more precise rate of sustainability of the micro-lending could be investigated by comparing the loan amount of lending to micros with the full size of expenditure enlarging income. However, this is still not very precise and lacking a realistic figure for bad debts due to the short term since programme implementation and the one year grace period.

<sup>29</sup> The other main players in the market for financing SMEs and micro-enterprise are: *Merita* bank - the dominate bank in Finland, *Leonia Bank* the postal bank and the small local banks, saving banks and co-op banks spread around the country.

process. To reduce the potential for conflict FINNVERA tries to avoid direct competition with the banks.

The major technique for co-operation could be described as "*steps of sharing risk*". According to our interview partner a typical client relationship career is as follows:

1. Micro/ start ups: For start ups with needs for small loans, FINNVERA is the entrepreneur's only bank partner. It lends money for investment and for working capital.
2. Small business: For larger investments, FINNVERA co-operates with a commercial bank.
3. Medium size: In growing companies FINNVERA acts mainly as a collateral organiser.

This picture could be described as making a client bankable, introducing him to a commercial bank, sharing the risk while the business develops and then leaving the established business to use commercial banking alone. This can be seen as an active two-way referral strategy.

(A very good picture of that process is given on the KERA slide: "*The Steps of Growth of a Microenterprise*".)

According to FINNVERA the daily contact between the banks and the local branches is functioning very well, see also section "Client recruitment"

## **Non- financial service**

FINNVERA does not provide many non-financial services. However, it is clear that part of the extra time FINNVERA spends on each micro-client in comparison with ordinary banks could be characterised as non-financial services and support.

Many of FINNVERA's loan officers work in small and isolated locations which gives them a unique understanding of the area's market situation. It also raises some potential problems as to how to use this information when dealing with clients. According to FINNVERA's internal rules the loan officers must not help some clients more than others. The organisation has to be neutral in the local competition.

More directly, FINNVERA has developed a range of well known and used hand-books about: General management, Cash flow management, Marketing, Business planing. These books are available for Euro 80.

FINNVERA also carries out some of the necessary paperwork, a company needs once it is established and charge for this service. The amount and type of service the entrepreneurs can get and their prices varies between the branches.

FINNVERA works closely together with the "*State business service centres*", see also section "Client recruitment".

## Benchmarking Case study

# Fundusz Mikro, Warsaw Poland

Date of visit: October 26 to 28, 1998

*Executed by: Jan Evers, Adriaan Loeft*

### Objectives and vision

Fundusz Mikro is a limited liability company which was established in Poland in December 1994. It is wholly owned by the Microfund Inc (MF), a not-for-profit organisation, established under the 1989 Support for East European Democracy Act (SEED Act), in the USA. The sole shareholder of Microfund Inc. is the Polish-American Enterprise Fund.

In one annual report<sup>1</sup> contains the following mission and vision statements:

#### *Mission:*

- to be the premier micro-lending institution in Poland
- to be one of the leading micro-lending institutions in the world
- to contribute to the advancement of the micro-lending industry

#### *Vision:*

To offer loans, savings, other financial and non-financial services to Polish micro enterprises.

To facilitate the work of other micro-lending institutions in Poland as well as their client's enterprises by promoting changes to the legal, regulatory, tax and accounting environment.

To adapt existing foreign micro-lending methodologies for use in Poland; to develop new, innovative methodologies and practices which could be applied outside Poland; and, within practical limits, to make the benefits of our experience available for world-wide industry use.

The above quoted mission and vision statements, are complemented by more operationally oriented goals, aiming at short- and longer-term operational and financial sustainability. These are:

#### *Goals:*

To achieve annual operating and financial goals, e.g. numbers of active clients; repayment rates and financial self-sufficiency indices.

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<sup>1</sup> Year ending 30 September 1997

To cover Fundusz Mikro's annual operating costs, including imputed costs of capital, with annual revenue from clients.

To be able to attract long-term borrowing as well as short term deposits from firstly, semi-commercial and, then, fully-commercial financial institutions.

## Short history

FM started with just one expatriate initiator and no formal staff at all. The financier (The Polish American Enterprise Fund) had made a credit of USD 20 million available to initiate lending activities. The first FM management undertook a world wide survey of methods and techniques in all well known micro credit programmes and institutions. The most suitable and effective methods and concepts, together with four different lending methodologies, were then tested in 9 pilot projects during the first year of operations. The pilots were conducted with the lessons learned from each project, even those which failed, would become part of an ongoing, incremental process to devise a better system. The pilots ended in March 1996 and the current systems appear to be well-suited to Polish conditions and needs.

*“Stepping into the micro-credit market in Poland was like stepping into a lake, not knowing how large it is, whether it is deep, or whether it can be frozen.”*  
(quote from CEO)

## Organisational structure

Currently, Fundusz Mikro (FM) has 33 Branches spread over the whole of Poland, with a total staff of 63. In addition there are 7 Regional Managers, who oversee the operation of the branches. Lending activities are managed by the Loan Operations Director. There is also a Credit Manager. Together they form the front-office operation. In addition, FM has a marketing and PR department with its own manager.

The back-office operation consists of a Chief Financial Officer, supervising an accounting department with four staff and a chief accountant; a loan administration department with four staff, led by the Head of Loan Administration; a Personnel and Training Manager; an Information Systems Manager; an Office Manager; and one receptionist. FM is managed by a Chief Executive Officer. An internal auditor reports to the board. In total, FM employs in October 1998 94 staff.

FM makes use of only a few aspects of regular banking systems and operations:

- The organisational structure (front office, back office, credit management).
- Financial management systems.

- Credit risk assessment (by three assessors - "Citibank approach"; scoring system).

## The market and the client profile

Clients are generally engaged in running small businesses, such as market stalls, retail outlets, taxis and private car hire, small construction and plumbing businesses, and repair services. FM only provides finance for existing business are financed, it does not support business start-ups.

FM defines there borrower profile as follows:

"Owner of a business

- registered at least 3 months previously
- employing fewer than 10 people
- profitable and in a positive cash flow situation
- not currently in debt and unable to access appropriate bank credit."<sup>2</sup>

Clients are 38% women, 62% men. The type of business is 54% trade, 35% services and 11% production.

Credit from FM generally provides working capital, mostly to purchase stock. Sometimes, however, loans are used for small investments in equipment, the replacement or upgrading of tools, or expansion of premises.

FM only advertised its services on a national level when it was first set up. Since then, word-of-mouth promotion has been the main basis for expansion of the client base. Branch managers do their own localised promotion. Advertising in newspapers is mainly used to demonstrate that it is an open service.

## Facts and figures

FM is represented all over Poland. The first loan was disbursed in February 1995. The following table provides an overview of the scale of the operations of FM per 30.09.1998.

1.	Number of loans disbursed since inception	17.000
2.	Amount of loans disbursed since inception	USD 27.700.000
3.	Average loan amount	US\$ 1.628

<sup>2</sup> presentation of Krzysztof Jaczewski to Round Table of Bankers and SME, Vienna, April 15, 1999

4.	Average loan term in months	8,44
5.	No of employees	94
6.	Total number of loans disbursed in 1998	10.700
7.	Amount of loans disbursed in 1998	US\$ 19 million
8.	Loan balance outstanding for 1998	US\$ 8.6 million
9.	Administrative expenditure for 1998	US\$ 2.47 million
10.	Credit losses/Write off's for 1998	2,36%
11.	Delinquency rate for 1998	2,24%
11.	Income from clients in 1998	US\$ 2.1 million
12.	Re-financing costs	0 %
13.	Estimated rate of survived enterprises (after three years)	Approx. 85%

## Financial services and credit delivery methodology

### Client recruitment

Client recruitment is done mainly on the basis of mouth to mouth in the business community. The strongest element is the self-interest of a potential borrower to find other borrowers to form a group but to select them carefully in order to avoid having to step in if they default.

### Credit delivery methodology

Three starting principles form the basis of the lending methodology:

- a) FM charges commercial interest rates
- b) FM tries to overcome the widespread problem of lack of collateral by using personal guarantees of a group around the entrepreneur (either guarantors or other entrepreneurs in a credit group)
- c) The borrower is assured access to follow-on loans if they repay on time.

Clients only qualify for a second loan if their first loan has been fully repaid exactly on schedule. Second loans can generally not be larger than 150% of the first loan.

Borrowers provide no business plan and give no official documents confirming their income. Their word is trusted (unless informal investigations prove them to be untrustworthy) and self assessment is a key part of the loan granting process.

The steps in the loan procedure are the following<sup>3</sup>:

- a) First contact with borrower – by phone or in the office: examination on basis of formal criteria and informing the borrower about the further process and what to keep in mind for identifying further group members
- b) Meeting with group of borrowers in the office: discussion of mutual obligations, examination of personal links between borrowers, examination of group risk factors
- c) Individual meeting with group members: examination of their motivation and business skills, re-examination of links between group members
- d) Visit the borrowers businesses: evaluation of their businesses
- e) Analysis: evaluation of risk related to group aspects, borrowers motivations and business skills, viability of the businesses, stability of cash flow
- f) Recommendation: joint proposal of two loan officers who had to contact borrowers
- g) Approval: joint decision of two loan officers who recommend the loan and approving person who must not meet the borrowers but approves the way the risk was evaluated
- h) Commitment: signing the loan agreement with all group members and co-signers
- i) Disbursement: from FM's central bank account to borrowers' accounts or to the group co-ordinator's account
- j) Repayment: bank transfer to FM's central account made by individual borrowers or jointly by the group co-ordinator
- k) Monitoring: Visiting the borrower and/ or contacting by phone in order to maintain good relationships, discuss plans for the future and stimulate timely repayments

### **Cost and terms of services**

The terms of the loans vary from 3 to 12 months.

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<sup>3</sup> Round Table presentation, see above

## Individual loans

An individual client has to provide three personal guarantors whose assets and income are also assessed. The interest rate for individual loans is 37%<sup>4</sup>.

## Group lending

73% of loans are provided to clients in groups. The interest rate for clients in a group is 29% or 30%.

Groups have at least four members, and generally consist of up to seven members. (Smaller groups have to present personal guarantors to complete the “group”. For example, two borrowing members must present two guarantors; three borrowing members have to present one guarantor).

The differentiation in interest rates between group and individual loans provides a “market mechanism”, encouraging clients to form groups.

## Loan administration system

The time between the first visit of a group to a FM branch and the disbursement of the credit ranges from ten to fourteen days.

An LO (loan officer) spends, on average, about four hours per client or loan application during the appraisal process.

The credit operations manual is reviewed on an annual basis.

All loans are administered by a central unit inside FM's head office in Warsaw where three people are employed for the loan administration as to hand out loans, identify regular payment of instalments, inform branch managers on late payments and the loan documentation. All information on disbursed loans and payments made by clients are here typed into a computer database system (based on Excel, from spring 1999 transferred to an access system) provides the loan officers and the managers with information about the loan-portfolio and defaults rate and so on. A table summarising the most important indicators for each branch and for all of FM is send monthly to all branches to make sure that they are aware of the general and individual performance.

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<sup>4</sup> Inflation stands at 8.5%, prime lending at commercial banks would be 24%, an overdraft facility would be 30%, inter-bank LOMBARD stands at 23.5%. Repayment and interest calculation is based on annuity repayment schedules, given equal payments per period.

## Risk management

### Credit worthiness assessment:

Two or three FM staff members are involved in the appraisal of loan applications.

Loans are approved by a three person credit committee. The LO (loan officer) visits the client and completes a two-page risk evaluation form (see annex 1). If it is deemed necessary after the forms are submitted, the Branch manager will also visit the client. The application is finally presented for approval to the Regional Manager (who is not known to the client) for the final decision. For loans of more than Z 20,000 the HQ Credit Operations Director provides a third perspective.

The credit worthiness criteria used in decision-making are:

- (1) Motivation to repay
- (2) Entrepreneurship / Entrepreneurial skills
- (3) Business viability
- (4) Cash flow coverage

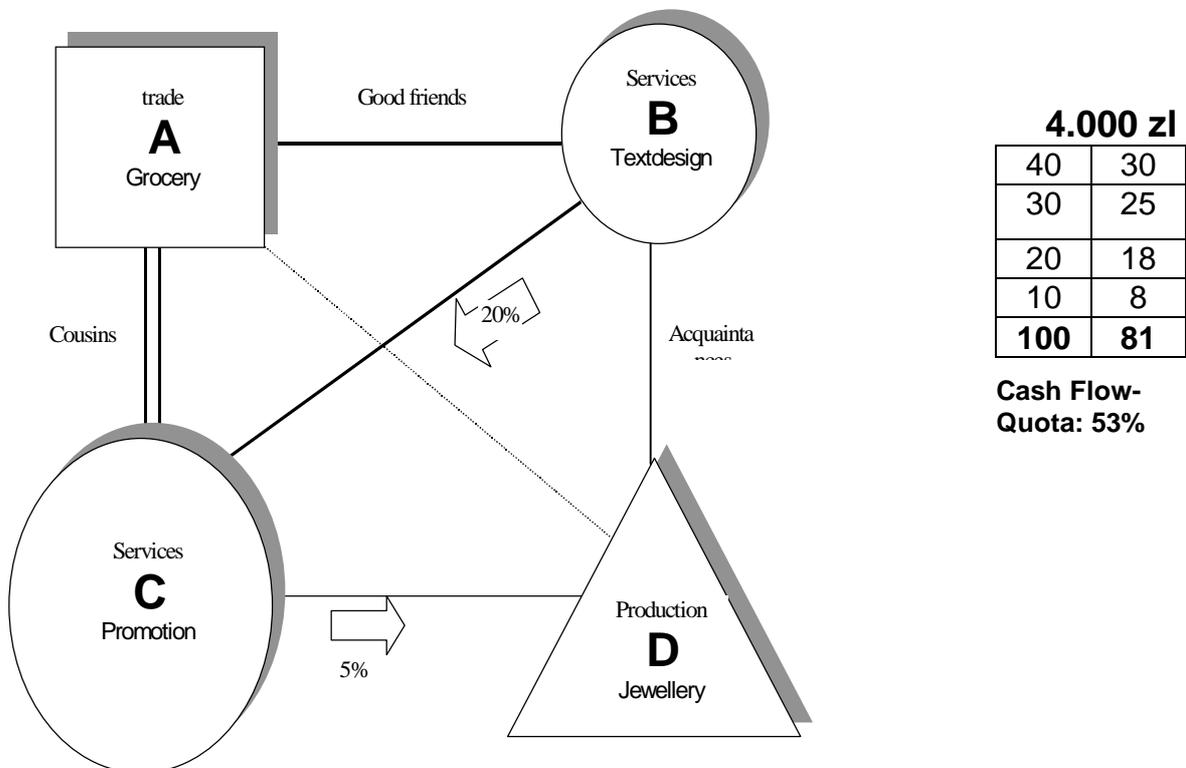
For a first and small loan of, for example, Z 5000 the criteria are given a weighting factor of 40, 30, 20, and 10 respectively, in order of their relative importance. The weighting is adjusted according to the size and nature of the loan. For a second loan of Z 30,000, for example, the weighting is 10, 20, 30 and 40 respectively. The client is already known to FM, the requested amount is bigger, and the importance of cash-flow for debt servicing has increased.

For individual loans the co-borrowers are only accepted if they have a regular income which allows them to repay the loan if the borrower fails to do so.

For group loans the factors determine the reliability of the group network are assessed: personal links, trade links, risk concentration and relative growth prospects. These factors are documented (very quick by hand) in a picture. See the following example:

- All members of the group are liable for debt servicing (joint and several liability)
- Clients form their own groups. The principles are explained to potential clients and group formation is left to the clients' initiative. Often family or existing business ties form the basis for the group.
- The linkages between the group members are depicted in a clear schematic drawing.

For each of the group members an individual scoring of the four credit worthiness criteria is undertaken (see above) – the results of borrower B can be seen in the graph below.



### Ensuring payment and debt recovery

No physical collateral is accepted by FM because they believe it would weaken borrowers' sense of personal responsibility for repayment. The "motivation" to repay is assessed in-depth, through the character of the client (see previous paragraph).

FM aims at establishing a long term relation with the client, which provides security in itself.

The essential security is provided by the fact that only small loans are available in the first instance, and that new and larger loans can only be obtained if the previous loan is repaid fully and on schedule. Thus, the expectation of a new, larger loan is a form of security.

Peer pressure or "social collateral" applied through group members is essential. If one member of the group does not repay on schedule, follow-up loans will not be available to anyone in the group.

Other important risk management issues are:

- Transparency in all aspects of the process is a crucial policy of FM. The client should know all the procedures and, in particular, the philosophy behind the procedures. This affords the client shared responsibility for proper adherence to the rules and regulations.
- The loan size is always smaller than 200% of the existing assets in the enterprise.
- All borrowers have to sign a blank “wechsel”/ bill of exchange. This officially recognised document legally allows the holder (FM) to claim any amount from the borrower. This makes any court proceedings much easier, and also has a strong psychological effect.

However, if a payment is late the local loan officer will be informed by the central back office within 48 hours and the policy is to get in touch with the client straight away.

### **Covering losses**

The strategy to cover losses is based on co-signers and co-borrowers who have been evaluated before approving the loan if they are financially strong enough to take over parts of the repayment responsibility. There is one exception: in the case that two group members fail, FM sees the responsibility within their own risk management ability and the remaining group members have to pay of only the first outstanding loan. This has happened only two or three times so far.

### **Loan administration and MIS**

FM has developed its own loan administration system. This is based on the Microsoft Access database package. 17,000 loans (of which 8,300 are active) are administered. The system is based on fixed repayments in a schedule.

The system is simple and therefore easy to operate. On the other hand, however, the system has limited flexibility and is, therefore, not able to handle partial repayments, different interest calculation methods or new credit products. A new system, also based on MS Access, is under preparation which will be much more flexible and advanced.

There is no linkage to an accounting package. The system allows import and export of data into and out of the banking system.

Transaction reports from the banks (ING) are processed on a daily basis. At night, reports of overdue payments are faxed or emailed to the branches for follow-up action.

### **Sources of funding and operational and financial sustainability**

FM has been financed from the beginning with a strong starting loan fund of US\$ 20 million from the Polish-American Enterprise Fund and an additional

fund with US\$ 4 million for technical assistance was provided by USAID. Until today the total USAID was used to cover operational cost of building up the branch network and all pilot programmes.<sup>5</sup>

According to their plan, all FM's costs will have to be covered from operational income by April 1999. By November 1998 FM was covering 86% of its operational costs from lending operations revenue. Additional revenue (such as interest on cash balances) provides a net profit for FM. On this basis, financial break-even point (whereby operational income covers operational costs and market based financial costs) could be achieved in two years.

FM does not hold savings or deposits. This would require them to become a formal bank and would place it under central bank supervision. This would make it impossible to apply the micro-lending approach it currently uses.

FM is actively looking for new investors, since portfolio growth will require additional sources of funds in the near future.

FM is aiming for greater efficiency, increasing the number of loans per LO, which currently stands at 120 loans per LO.

## Human resources

In October 1998 FM was employing 94 persons. Staff is recruited on the basis of criteria derived from the FM management principles of

- decentralisation, and
- individual accountability

Young graduates (from any educational background) are employed, who then complete full in-house training. (This consists of a one day introduction to FM and one month on-the-job training or twinning). A 3 months probation period is strictly applied.

Banking experience is a disadvantage rather than an advantage. FM's principle of credit delivery requires a different mind-set from commercial banking orientation. Knowledge or personal experience of the SME sector is a strong requirement.

The level of staff turn-over is reasonable - twenty people have left since FM began.

Lending Officers (LO's) are partly remunerated through a bonus system, based on quality and quantity of loans. In addition, supervising managers can, at their discretion, divide bonuses of up to 15% of salary budgets between staff.

## **Co-operation with formal Financial sector**

FM does not handle cash. It has no counter or cashiers.

All transactions are done through the regular banking sector.

One bank is selected, on the basis of its network and advanced electronic banking facilities and data exchange options, as the main partner (Kredyt Bank PBI – Polish retailer bank).

Currently there is no policy in transferring grown up clients (maximum loan size is 30.000 ZI) to other banks – mainly because the banks represented in Poland are not interested in small firms.

## **Non-financial services, such as Business Advisory Services (BAS)**

FM does not specifically provide non-financial services to its clients.

However, the LO spends a great deal of time with the client in the loan application phase (see risk management) and after the loan is disbursed. The LO visits clients who have active loans and, during these visits, provides limited business counselling.

The group process facilitates mutual assistance and advice among clients. However, the group process (e.g. number, timing and content of meetings) is left to the responsibility of the clients.

## Benchmarking case-study

# Glasgow Regeneration Fund, Scotland, U.K.

Glasgow, United Kingdom

*Date of visit: February 18 to 19, 1999*

Executed by Adriaan Loeff, Facet and Stefanie Jack, IFF

### Objectives and vision

The overall objective of Glasgow Regeneration Fund (GRF) is 'to encourage and nurture profitable and sustainable enterprises in areas that are amongst the most depressed and disadvantaged in Glasgow, and arguably in the UK'<sup>1</sup>. That means that the Fund supports, stimulates and develops enterprise opportunities in disadvantaged local areas of Glasgow. It is based on an awareness that people in these areas may have the skills to build up their own business, but have no access to traditional sources of credit. The provision of loans and equity promotes the growth of businesses and jobs in these areas. GRF's objective is to contribute to the strengthening of sustainability in 8 local Regeneration communities.

### Short history

*"The Glasgow Regeneration Fund was set up as a fund targeted at small business development projects in eight of the most disadvantaged areas of Glasgow – known as the Regeneration Areas. The initial concept was to create a bank similar to other initiatives in Europe. The idea was taken forward by the former Strathclyde Regional Council, Glasgow City Council, Glasgow Development Agency (GDA), and the Body Shop."*<sup>2</sup>

As a result the Glasgow Regeneration Fund was launched working under the auspices of Developing Strathclyde Ltd (DSL) which was also established in 1993. The initial funders were the GDA, Strathclyde Regional Council, Glasgow District Council, Royal Bank of Scotland, Body Shop International, BP and Scottish Homes. A Company limited by Guarantee, the organisation has Enterprise Trust Status. "Developing Strathclyde Ltd ... embraces the

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<sup>1</sup> Taken from 'An Introduction to the Glasgow Regeneration Fund' 1994

<sup>2</sup> LEDIS, Updated Initiative A588, April 1998, page 1

philosophy that a strong local economy is the foundation of a healthy community.”<sup>3</sup>

Under this ideological umbrella the organisation’s purpose was to encourage and stimulate entrepreneurship and job creation in the regeneration areas of Glasgow by giving micro-credit, and on occasion small grants<sup>4</sup>, to small enterprises and start ups. “Trade not aid” was the policy. The directors of Developing Strathclyde Ltd set a target of raising total funding of £3 million to be used for loan funding as well as for covering operational costs of the managing company (Developing Strathclyde Ltd.).

In the first three years (1993-1996) the funds raised were administered under contract by another enterprise trust called Glasgow Opportunities. The Glasgow Regeneration Fund did not operate an office in its first three years. In November 1996 a full-time Chief Executive was employed who oversaw the management of the Fund which, for the next 18 months, was still under contract to Glasgow Opportunities. The Chief Executive then started to build a small team, including a full time Fund Manager, to take the fund into a stable and balanced configuration.

## Organisational structure

The Board of Directors of Developing Strathclyde Ltd. represent the founding organisations from 1993, although there has been some change in the individuals since that time. The board of directors is constituted by members of the Glasgow Development Agency, the Glasgow City Council, the Royal Bank of Scotland, Scottish Homes, Community Enterprise in Strathclyde (since January 1988) and representatives of private industry.

The Glasgow Regeneration Fund (GRF) has grown in size and activity beyond all expectations and remains the principal activity of Developing Strathclyde Ltd. Thus GRF is in charge of all loan disbursement activities, the administration connected with loan disbursement and fund raising. Furthermore GRF conducts thorough research on its current situation and future developments so it can set a strategic path for the future development of the fund.

GRF operates a Main Fund which is distributed to the eight regeneration areas in Glasgow - Glasgow North, East End, Govan, Gorbals, Drumchapel, Castlemilk, Greater Easterhouse and Greater Pollok. Alongside the main fund, a number of joint regeneration funds have been set up with the Local Economic Development Companies that are based in each of the areas.

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<sup>3</sup> Developing Strathclyde Ltd; The Glasgow Regeneration Fund---A Foundation for the Future---A Briefing Note, page 1

<sup>4</sup> GRF no longer awards grants

Five of these eight LEDC's contribute some of their (usually public) funding to these joint funds. This money is matched by the same amount of money from GRF. The resulting joint fund is consequently used for local loan disbursement. The five LEDC's which have set up local joint funds are: Glasgow North Ltd, Greater Easterhouse Development Company, Drumchapel Opportunities, Gorbals Initiative and Castlemilk Economic Development Agency. The remaining three LEDC's (East End, Govan, and Greater Pollok) do not have their own funds and just receive funding from the main GRF fund.

GRF is currently investing a portion of the main fund in a number of special projects, one of which is the Glasgow Women's Microcredit Project. This program works with a group-lending scheme and is located in the East End of Glasgow. Capital and advisory assistance are contributed by GRF.

GRF's office is located in the centre of Glasgow (not in one of the eight regeneration areas) and employs a total of four people, augmented by private sector secondees, when available.

### **Human resources**

GRF's office is located in the centre of Glasgow (not in one of the eight regeneration areas) and employs a total of four people, augmented by private sector secondees, when available.

The Chief Executive is the first person to mention. In addition, there are up to three fund managers (one directly employed Fund Development Manager and up to two seconded fund managers) who are responsible for managing the loan disbursement, loan administration and loan collection; one Research and Information Manager in charge of reporting on performance, developing new projects and overseeing the day to day running of the office; and one administrator who supports the Fund Managers, Chief Executive and Research and Information Manager.

As mentioned above two of the fund managers are seconded from the banking sector. None of the other staff members are recruited from the banking sector. The business advisers in the LEDC's, who are working with clients directly have extensive management experience from the private sector.

Members from the Board, Approval Panel and Advisory Group are recruited from public sector institutions (Glasgow City Council; Glasgow Development Agency) and from the private industry. These people are either appointed by their organisation or they are headhunted by GRF.

### **Target Group and client profile**

The Glasgow Regeneration Fund supports small and medium-sized enterprises in the above mentioned eight regeneration areas of Glasgow. These areas are characterised by a high rate of unemployment and a very weak socio-economic

structure. Support is spread at the micro level (socially directed investment) as well as to the macro level (socially responsible investment).

Approximately 50% of GRF's clients are new business start ups, and 50% are existing businesses. The only trading status which is recognised are sole traders/ partnerships and 'limited' companies.

### Facts and figures Main Fund plus the LEDC funds

1.	Number of loans disbursed since inception (as at 31/3/99)	227
2.	Amount of loans disbursed since inception	£ 1,918,741
3.	Average loan amount	£8,500
4.	Average loan term in months	24 to 60 months
5.	No of employees	4(6)
6.	Total number of loans disbursed in 1998/99	46
7.	Amount of loans disbursed in 1998/99 (April 1998 to March 1999)	£395,100
8.	Loan balance outstanding for 1998/99 (31.3.99)	£565,000
9.	Administrative expenditure for 1998/99	£175,000
10.	Credit losses/Write off's for 1998/99	£80,000
11.	Delinquency rate for 1998	N/a
11.	Income from clients in 1998/99	£129,800
12.	Re-financing costs	0
13.	Estimated rate of survived enterprises (after three years)	44%

### Financial services and credit delivery methodology

#### Client recruitment

GRF is known in the local community through articles about the fund's activities in the local media. Furthermore they distribute leaflets through a number of community based organisations and advertise a freephone telephone number as part of the Business Shop network.

As almost all loan applications are currently channelled through Local Economic Development Enterprises the main client recruitment comes through business advisors working in these LEDCs. Information material and leaflets about GRF is placed in all eight LEDCs, in libraries and job centres.

GRF is currently in discussion with banks on the possibility of them referring clients who make unsuccessful loan applications to the banks. This system has not yet been implemented.

### **Current Products and plans for future products**

GRF's main products are loans for existing small and medium-sized enterprises. The loans are typically small scale, between £1,000 and £30,000. Average loan size is £11,000. Loans are normally agreed to be paid back after a period of 2 to 5 years.

GRF also funds equity and sometimes issues bank guarantees for overdraft facilities for their clients. The fund has also been issuing grants to selected companies, although they are trying to phase out these grants. To date, GRF has disbursed 88% loans, 9% grants and 3% equity.

GRF is currently in the process of setting up pilot projects specialising in providing microcredit to individuals attempting to set up a business. These loans are managed as group loans, where each member of the "*business credit group*" vouches for each other. These small loans are available to small existing companies as well as start up's. The exact procedure of the loan disbursement and credit collection for these "*business credit groups*" is still at a pilot stage, hence has not been described here.

As part of the Glasgow Women's Microcredit Project, the Glasgow Regeneration Fund helps women who need reasonable small cash loans to set up their own business. The project is based at the Wellpark Enterprise Centre.

Wellpark Enterprise Centre was established to provide a centre of support and assistance to women's enterprise and business development. The Women's Microcredit project aims to provide an alternative means for women to gain access to small business loans. It also wants to raise the income of women in Glasgow.

To achieve these goals the Wellpark Enterprise Centre offers additional sources of (grant) funding to those who meet specific programmes' criteria, and also offers other services like:

- ⇒ Training in business skills
- ⇒ Giving information and advice to women starting a business
- ⇒ Help with creative business ideas and their generation and evaluation
- ⇒ Giving practical on-site assistance
- ⇒ Organise networking events for business women

⇒ Organising marketing and PR events for women in business

The group lending microcredit project offers very small loans, of between £200 and £3,000, and thus differs in size from GRF's conventional loan product. In addition, the provision of assistance and training targeted at women thinking of setting up in business is new in Scotland.

GRF is also considering a project to provide microcredit in co-operation with the "Big Issue" initiative. This initiative helps unemployed and homeless people to earn some money by selling the magazine "Big Issue". Once they have found accommodation and thus can no longer sell the magazine, GRF plans to offer those former vendors who would like to go into self-employment the opportunity to obtain small business loans. This idea however is not yet fully developed and hence is not included in this report.

GRF is also building up a track record in socio-economic analysis and reporting. They receive information from a wide variety of sources and collates the information for interested parties. In particular, GRF is building up an expertise on 'access to capital' issues in Scotland. "*GRF is providing intelligence*".<sup>5</sup>

Last but not least GRF is seeking to expand the microcredit approach beyond the borders of Glasgow. They would like to set up a partnership or joint venture approach with other city councils in order to establish a "pan-Scotland" fund.

### **Credit delivery methodology**

Applications for loans are channelled through the Local Economic Development Companies. The LEDCs are specialised in giving people advice in how to set up their business, advice on developing their businesses and help with a number of other business related services. The business advisers in the LEDCs can help with drafting a cash-flow and a business plan and give advice in management and marketing issues.

Once the client expresses the need for a small loan the local business adviser will help him to complete the loan application form and will write a report on the business structure. The loan application must be accompanied by the following information:

- ⇒ Number of employees living in the regeneration areas
- ⇒ Details of existing employment
- ⇒ Forecast of future employment
- ⇒ Credit check

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<sup>5</sup> Quote of David Brown, GRF Chief Executive

- ⇒ Copies of correspondence with other lenders approached
- ⇒ C.V.' of all applicants
- ⇒ Personal and financial profiles of all clients partners or directors of the applying company
- ⇒ Details of the full funding package being sought
- ⇒ Details of available security and security being given to other lenders
- ⇒ Details of proposed expenditure
- ⇒ Detailed business plan and financial projections incorporating two years cash flow
- ⇒ At commencement of the contract the company is requested to set a management account reporting system in place
- ⇒ All directors loans to be injected and in place as share capital prior to loan/grant agreement
- ⇒ Documentary evidence of other lending sources

For applications to the main fund, the GRF Fund Manager presents the application to the main approvals panel. The application is presented with both the Fund Manager and LEDC advisor's recommendation. The local joint funds vary slightly from the main fund, and also from each other as each local fund has been set up according to local need and circumstance, the approvals procedure of each may vary. Applications to the local joint funds may be presented by the LEDC business advisor or by the client him/herself (or by both).

The loan maximum for each of the funds varies from fund to fund, and whether the client or business advisor presents the application also varies. In all joint fund cases, the GRF Fund Manager can vote but does not usually exercise that vote unless there is a split decision amongst panel members. Across all the funds (including the Main Fund), should the client be turned down he may apply again. (No fixed time scale). Clients are rarely refused funding outright, but applications may be deferred pending more information required, or criteria met. Prior to presenting the case to the local approvals panel, the business adviser will meet with the client in their own premises in order to get a better understanding of the business.

If the loan applied for is higher than the maximum of the local joint funds, the LEDC business adviser submits the application to the Fund Manager at GRF's office. The Fund Manager visits the business (often with the business advisor), checks the application form with all appended material, writes a short report on the client's situation and presents the application with his 'recommendation' to the main panel. The main panel constitutes members of the Glasgow Development Agency, Glasgow City Council, Royal Bank of Scotland, business people and accounting experts from private industry. Members of the main panel are a mixture of representatives from the public and private sector.

The main panel meets approximately 10 times a year. Usually the decision about whether the client will receive a loan will be made on the day of

presentation. In 90% of all presented cases the main panel will accept the fund manager's recommendation. Fund Managers are not allowed, however, to present a loan application made directly to him, to the main panel. He may only present applications channelled through business advisers at LEDC's.

If the loan applied for is higher than £20,000 the application has to be approved by the board of directors.<sup>6</sup>

### **Cost of services**

The interest rates charged by GRF are between 2% and 3% higher than the prevailing bank base rate. The normal bank interest rate in Scotland is between 4% and 15% higher than the base rate. This means that GRF provides much cheaper loans than banks. GRF usually does not charge any fees for their services. Charges are only made if legal services are involved.

### **Loan administration and MIS**

All loans are administered centrally at GRF Head Office for all eight LEDC's.

Money is transferred to GRF's bank account by the client once a month via standing order. The dates for payments are currently the 2<sup>nd</sup> and 20<sup>th</sup> of each month.

At the GRF office all payments are recorded on a loan database set. However, as this system is quite old and does not comply with recent requirements a new system is currently being tested and implemented, which uses File Maker Pro. This system collects and provides more management and statistical information than the one currently in use. The new system is custom-designed by an IT consultant, overseen by the fund manager of GRF and means that dates for repayment are not set for the 2<sup>nd</sup> and the 20<sup>th</sup> of each month but can be more flexible, according to the day of the month when the loan was disbursed. For safety reasons, both computer systems will be used parallel for some time.

Each GRF client has a bank account. GRF receives bank statements twice a month. Five days after payments are due GRF receives the bank statements and is able to monitor its overdue accounts.

### **Risk management**

As mentioned above there are three levels of risk assessment in the credit approval process: Loan applications higher than £20,000 need the approval of the board of directors. Loan applications between the maximum of the local joint fund and £20,000 need the approval of the main panel. For loan

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<sup>6</sup> Constitution of board of directors see chapter 1.3. Organisational Structure

applications between £1,000 and that maximum the risk assessment and loan approval is devolved to the local approval panel.

The new group-lending product should be mentioned here, which is a fourth level of credit approval. Microcredit is disbursed (an amount between £500 to £2.000) and will devolve the loan decision to the peer group itself. However, this project of microcredit for peer groups is in the process of being set up and hence will not be the subject of this study.

The following core criteria for loan disbursement are defined:<sup>7</sup>

- \* **Geographic**                   ⇒ The actual physical location or base of activity must be within the area boundaries of the specified regeneration/priority area (s)
- \* **Commercial**               ⇒ The application, enterprise or organisation must intend for their activities to be commercially viable (E.g.) for-profit whether for the benefit of the company or the local community.
- \* **Sectoral**                     ⇒ Applications from manufacturing and service sector(s) enterprises are sought and encouraged. Funding is not available for retail business.
- \* **Viability**                    ⇒ The application must establish, and provide evidence of, the viability, sustainability and prospects for medium/long term growth (sales, profit etc.).
- \* **Local Impact**              ⇒ The impact of the proposal on socio-economic grounds will be a key component (e.g. existing business expansion, new business creation, local job creation/retention, stock from local suppliers)

### **Ensuring payment**

If the applicant is not an experienced business person, GRF and the LEDC's try to ensure that he has received proper business and management training in cash-flow planning and business-planning prior to receiving the loan.

Once the loan agreement is signed and the cheque for the client is issued, it's the business adviser's responsibility to look after the client. GRF's approach is to ensure payment via good and careful client after-care. The business adviser receives a monthly payment report from the fund and after-care manager. With this material he is asked to visit the client approximately every three months, the first visit being after 6 weeks. Every three months the business adviser is

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<sup>7</sup> Developing Strathclyde Limited, GRF/LEDC Local Regeneration Funds Operating Manual

supposed to write a short report on the client's business. These reports, however, take quite some time and very often the advisers are not able to present them on time. That means that the fund manager sometimes only receives these reports on a six monthly basis.

GRF does not charge any penalty to the client for delayed payment. However through the banking system the bank charges a £25 penalty to the client if a standing order is assigned without the necessary capital being available on the client's account.

Should one instalment not be paid, the client will be telephoned by GRF and contacted by the business adviser about 14 days after payment was due. In case two instalments are missing the client will be visited by the business adviser and on a case-by-case basis by the fund aftercare manager. Debt collection letters are sent out if this seems necessary. However GRF does not have any standard letters for these purposes. A standardised and obligatory debt collection procedure is not set up by GRF. The procedure is determined on a case-by-case basis.

### **Covering losses (Collateral or security)**

GRF/LEDC operating manual asks for security from the clients and in the case of a small enterprise it asks for personal guarantees and for bigger companies other appropriate security (like business property) is asked for.

However in fact GRF is very reluctant to ask for collateral or security from the client. It is GRF's policy that it does not call up the security given unless fraud is suspected. Should a sole trader for example prove to have been doing his best and still not able to pay back his loan, GRF will write the loan off. During the entire period of disbursement of 216 loans, security has been successfully collected in only three cases.

### **Debt recovery**

As mentioned above the business adviser will visit the client 6 weeks after loan disbursement in order to check how the business is developing. A monitoring report about client's business is supposed to be written on a quarterly basis for the fund managers at GRF to keep an eye on the loans.

If a client is honest about his business problems and is able to explain his repayment problems it is very likely that GRF will give a capital holiday of three to six months. In this case neither interest nor capital is collected. The other option is to re-schedule the existing agreement. A new repayment plan will be agreed upon. Should letters be ignored and visits be useless legal action will be taken. However, according to GRF staff, this is very seldom the case.

## Sources of funding and operational financial sustainability (including transaction costs)

The following organisations and companies have contributed to GRF's main fund, which adds up to over £3 million:

European Union European Regional development Fund (ERDF), Glasgow Development Agency, Whyte & Mackay, Glasgow City Council, former Glasgow District Council, former Strathclyde Regional Council, Atlas Investment, Glasgow North LTD, Grater Easterhouse Development, Drumchapel Opportunities, Combined Property LTD, The Body Shop, Scottish Homes, Royal Bank of Scotland, British Petroleum.

There is currently no information available as to percentage of contribution from the respective organisations.

From the total fund of £3 million GRF has invested £1,918,741 to end of March 1999. 88% of this money is invested in loans, 9% in grants and 3% in equity. The annual operational costs were £175,000 in 1998/99. The total fund invested in loans over the same time period was £395,100.

Looking at GRF's investment and fund balance, the total loan capital disbursed plus the operational cost plus the write-off's, in relation to the money incoming from interest rates and loan collection, there is evidence that GRF is loosing £200,000 per year. Hence loan capital is reducing and the fund itself will not be able to survive unless further grants and funds from the public or private sector will come in.

## Co-operation with formal financial sector

The co-operation with the banking sector is established through financial support and in-kind support. From the Royal Bank of Scotland GRF received about £25,000 and banks have provided secondees to work for GRF in loan administration and collection. One Fund/Aftercare Manager is seconded from Bank of Scotland and one Fund Manager has been seconded from the Clydesdayle Bank.

The bank's motivation to provide secondees is to learn to understand the economic "enterprise network" in Glasgow and Scotland in order learn more about the needs of 'micro' clients and to build up a good network of enterprise contacts. Furthermore, they want to contribute, through better client support, to the future development of their customer base. *"To help GRF is one way for the banks to reach very small enterprises and to contribute back into the local community"*<sup>8</sup>.

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<sup>8</sup> Quote Anthony Dorrington, Fund Development Manager

This support however is not guaranteed for further years to come. In fact both employees will stay only with GRF for the coming two months.

Banks also provide members for the Board, the approval panels and the advisory group.

## Benchmarking case-study

# Industrial Common Ownership Finance (ICOF)

Birmingham, United Kingdom

*Date of visit: February 19, 1999*

*Executed by Stefanie Jack, IFF and Adriaan Loeff, FACET BV*

## Objectives and vision

ICOF seeks a commitment to equal opportunity; social justice; environmental concern and ethical business. Recognising that "people are the business", means that ICOF is prepared to increase its exposure to risk in order to provide opportunities that the mainstream financial institutions might reject.

Industrial Common Ownership Finance (ICOF) provides loans throughout mainland UK to co-operatives and businesses operating in the social economy.

*The primary purpose of ICOF's Funds is to encourage local economic regeneration by enabling local people to create, own and democratically control the business in which they work, or which operates in their local community.*

All types of social economy businesses are able to apply to ICOF, including co-operatives, community businesses, green businesses and businesses developed from the voluntary sector. The notion co-operative is very loosely defined.

ICOF provides financial services to those enterprises which practice or support the principles of co-operation; common ownership; employee, community or social ownership; workplace democracy and sustainable development.

The Social Economy comprises businesses which variously call themselves co-operatives, community businesses, voluntary sector businesses and social or green businesses.

## Short history

ICOF started its lending operations in 1973. It was originally initiated as the **I**ndustrial **C**ommon **O**wnership **M**ovement (ICOM). The movement was established to represent the "new" worker co-operative sector.

Between 1973 and 1976 capital was raised from individuals and supportive companies, notably Scott Bader a democratically owned chemicals company who provided a facility of £100k. It started very small. Providing loans of £200 to £500. In 1976 ICOF was recognised as the appropriate national body for co-

operative financing when the Industrial Common Ownership Act was passed through parliament.

Until 1979 ICOF employed two staff members. In 1985 ICOF employed 2 lending officers and a general manager.

Between 1976 and 1985 ICOF managed to obtain fund management contracts from many local authorities (Local community Development Agencies, Enterprise Development Funds). Local authorities were coming under stronger central control and looked to ICOF to put control of their funds with a third party.

Presently the ICOF group employs three full time staff members, all active in lending operations, and one of them responsible for general management.

Total assets of ICOF amount to approximately pnd 2.5 million.

## Organisational structure

The ICO Movement (ICOM) is represented in ICOF through two seats on the board of ICOF Ltd.

The ICOF Group is governed by a Board of trustees, consisting of 10 trustees. The Group consists of **ICOF Ltd** (Limited by guarantee). ICOF Ltd has about 150 members This entity serves as a holding company. ICOF Ltd manages a number of funds for local authorities and provides all the back office services for these funds. The total resources amount to approximately £1,000,000. ICOF Ltd employs all staff and has the IMRO licence<sup>1</sup>.

ICOF Ltd wholly owns a public share company, **ICO fund Plc**. ICOF Plc was established to raise additional funds through share issues. The shares are redeemable preference shares. The total resources mobilised by plc are approximately £1,000,000. Minimum investment is £250.

In 1994 **ICOF Community Capital Ltd** (ICC) was established. ICC is a society for the benefit of the community and although under the ICOF brand is a separate and independent organisation. ICC is managed by ICOF under the terms of a service level agreement. The purpose of Community Capital is to open up the possibility of lending to other clients (individuals and development trusts) than only co-operative or common ownership based businesses. Community Capital also lends to general community businesses, Local Enterprise Development Companies and social enterprises. Community Capital has raised approximately £500,000, through some 400 members, each investing about £1250. Another £500,000 is expected.

ICOF limited has also established **ICOF Guarantee Company Limited**. The purpose of the guarantee company is to establish a fund in which waived

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<sup>1</sup> IMRO is a self regulatory organisation, and has been established under the Finance Services Act. IMRO supervision is needed if one manages funds of others.

dividends and interest payments are accumulated. Investors indicate in their contract what they want to do with their dividends. The fund then serves as a provision for any loan losses made on the ICOF Community Capital loans.

ICOF operations are under the control of the Investment Managers Regulatory Organisation (IMRO). ICOF Ltd holds the IMRO licence.

## Staffing

Presently ICOF has two full time lenders as staff. One located in Cambridge, the other one in south Wales. The general manager is based at the head office of the ICOF group in Birmingham. He supervises the lenders operations (appraisal reports) and takes final decisions on credit approval. All administration of ICOF is done centrally by the general manager. In addition, from a few months ago, a part time administrative assistant is employed in Birmingham.

## Target group and client profile

ICOF is in the business of "social investment". Its mission is to provide access to finance for categories of people (businesses) that otherwise would not have access to finance.

This is the starting point. When such a client is identified, THEN financing is provided on a sound, transparent and business-like basis, where, if needed, legal action is also taken against clients.

Borrowers must be engaged in an income-generating activity, where a sufficiently strong cash flow is generated.

To be eligible for the different sources of funding they must be either organised in a common ownership structure, or be a community-based enterprise, active in the social economy.

The definition of a co-operative is rather general:

- 51% ownership of voting equity by members of co-operatives
- free and open membership
- equal voting rights
- more than 50% of workforce are members
- having a dissolution clause
- operating a viable business

ICOF is also, on a limited scale (10 to 15% of its portfolio), involved in so called "bricks and mortar" loans (mortgages). It does only "gap funding", providing the

last remaining 30% of funding. Term is generally 10 to 15 years. This loan category also serves as a buffer to spread risk in the total portfolio.

## Facts and figures

1.	Number of loans disbursed since inception	500
2.	Amount of loans disbursed since inception	£ 5.000.000
3.	Average loan amount	£10.000
4.	Average loan term in months	6 months to 10 years
5.	No of employees	Under 5
6.	Total number of loans disbursed in 1998	52
7.	Amount of loans disbursed in 1998	£500.000
8.	Loan balance outstanding for 1998	£925.000
9.	Administrative expenditure for 1998	£160.000
10.	Credit losses/Write off's for 1998	£29.000
11.	Delinquency rate for 1998	3%
11.	Income from clients in 1998	£104.251
12.	Re-financing costs	-
13.	Estimated rate of survived enterprises (after three years)	90%

## Financial services and credit delivery model

### Client recruitment

Promotion has not always been done in a very structured way. Recently a more pro-active attitude was adopted. Promotion is done throughout mainland UK. Word of mouth is one of the most important sources of new clients.

ICOF often uses inserts (flyers) in magazines that target potential client or investor segments, to promote its activities. Approximately 25% of clients that approach ICOF do not obtain a loan. They are either discouraged from going ahead, or withdraw themselves. Approximately 90% of clients who actually make a formal application will receive funds.

## **Current products and plans for future products**

Loans are minimum £1000 (although actually below £5000 no profit is made) and have a maximum of £50.000.

Interest rates are 1) variable rate is base + 4%

2) fixed rates are 9 to 12.5%

Presently base rate stands at 5.5%. The average rate charged is around 11%. The rates charged by ICOF are very much in line with commercial mainstream lending.

The terms for the loans can vary from very short bridging loans, to 15 year investment loans, with a bullet repayment after 10 years.

A declining (annuity) system is used to prepare repayment schedules. The MIS system automatically calculates the repayment schedule.

In the future, ICOF intends to become a service provider for Social Investment Funds. It will design such funds, provide management advice and back-office administration systems. A manual has already been prepared to do this.

## **Credit delivery method**

The turn around time for approving a loan can be as short as 6 days. Once the loan agreement has been signed, the credit is transferred to the client bank account.

The system is very basic and straight forward. There are not many present formats and requirements to follow. It is very much up to the personal assessment of the credit officer to decide about the credit worthiness of the client (see also paragraph 1.8)

## **Cost of services**

On each loan, a fee is levied of, target, 1.5 %. However, this fee is applied in a flexible manner, depending on the actual effort it has taken to do the appraisal and processing of the particular loan. The fee is subtracted from the loan disbursement, and an invoice is issued.

In addition (additional cost item) the borrower must become a member of ICOF, at an annual membership fee of £8 per year, or alternatively, the borrower must become an investor member of the community capital society at a minimum of £250 which is redeemable.

## **Loan administration and MIS**

The ICOF group has developed its own professional and advanced loan tracking and fund management system. It uses EQUINOX 2 database application software, developed by Compssoft. The financial administration

system also handles the funding side of ICOF operations, tracking individual accounts of investors, producing share certificates, and share account statements.

In addition, for its accounting, ICOF uses the SAGE accounting software.

Data from the MIS database are "exported" to SAGE through reports generated by the database. There is no direct linkage between the two packages.

Since the system is based on a database, all kind of reports on individual loans and total loan portfolio can be generated. Missed payments are signalled by the system after two days of their occurrence.

## **Risk management**

### **Credit worthiness assessment**

Clients are made aware of ICOF services through brochures, that include a simple loan application form. The application forms require preliminary information about the business to be financed and the persons involved and employed, especially ethnical background. The applicant also provides authority to ICOF to make credit reference enquiries and any other enquiries. The form has to be submitted with a written proposal. There is no formal format for proposals/business plans, but formats are suggested in an explanatory booklet. Business plans are generally not more than a few pages. Cash flow projections are made.

All serious applications are visited by a lending officer, for an average of half a day.

The lending officer prepares an appraisal report, which is submitted to the general manager, with a recommendation. ICOF recognises that appraisal always has a subjective element. It is essential that the judgement of the lending officer is finally justified by the results.

After credit is granted, clients have to submit management accounts every quarter to ICOF.

As mentioned before, there are no precisely defined criteria for the credit approval decision. This is left very much to the judgement of the lending officer.

### **Ensuring payment**

Repayments are made by direct debit from clients' bank accounts, giving ICOF the right to withdraw the payment from the clients bank account. If a payment is missed, within 2 days a warning is issued. Then mostly payments are still made but by cheque.

Payments are typically scheduled for the 18<sup>th</sup> of each month. Late payments are quite strictly followed-up by ICOF. In most cases payments are made after warnings are issued. If needed, legal action is taken.

## **Covering losses**

It is a policy of ICOF not to take personal guarantees because it does not want to force individuals into bankruptcy, or have them removed from their houses. Otherwise, any security that is available is taken. There is no minimum percentage set for securities. Often loans are not secured. Recently assets have been taken as collateral (chattel mortgage).

ICOF Guarantee has been established as a fund into which waived dividends and interests from ICC shareholders are accumulated. This whole fund underwrites all losses in the ICC. Using this fund also has tax advantages, by allocating it to the unit where losses are made.

The specific funds managed by ICOF Ltd take all losses made on the loans. Any revenues generated, can be accrued to ICOF.

## **Debt recovery**

As mentioned, payments are collected by direct debit. If clients have repayment problems, solutions are sought by suspending capital repayments for a certain period (capital holiday). Otherwise the loan can be fully rescheduled by closing the existing loan and opening a new loan with a new repayment schedule. In the ultimate case, legal action is taken, the business is closed and assets liquidated.

Rescheduling of loans is done whenever felt applicable, and is therefore used as a normal instrument to create a work-out solution.

## **Sources of funding and operational financial sustainability**

As mentioned before, the ICOF group actually consists of different entities, that have been established to serve as vehicles to raise funds, and to serve specific segments of the client target group.

### **ICOF Ltd.:**

Source of funds is mostly the capital it has in custody from local development authorities, and which it has to manage on behalf of those authorities.

Total amount stands at approximately £1,000,000.

### **ICOF Plc (owned by ICOF Ltd):**

Plc has issued shares to the public. The total investment stands at approximately £1,000,000, held by some 1000 shareholders.

### **ICOF Community Capital Society:**

Establishes its capital through membership shares. Minimum share is £250. Average holdings are £1250 per member. Total amount in the fund is

approximately £500.000, held by 400 members/investors. An additional pnd £500.000 is expected to be invested.

ICOF does not fully cover its operational costs. Income from earning assets with clients covers about 50% of operational costs and all loan losses. More efficient operational methods are needed. Its wide geographical scope (mainland UK) raises costs of operations.

ICOF generally monitors its efficiency of operations through cost per pound lent, which stands at a rather high level of 0.32.

Financial projections are made on a yearly basis, for three years in advance.

### **Co-operation with formal financial sector**

There is no structural co-operation with the formal banking sector, apart from making use of the common banking services, such as direct debits, and account statements.

Occasionally, joint-lending is done, especially for the so called "bricks and mortar" loans.

### **Non-financial services such as Business Advisory Services (BAS)**

In the early stages of contacts with potential clients, limited advice is provided in preparing a business plan, through dialogue with the client. They aim for a financial partnership. Through this relationship ICOF often becomes the "preferred creditor".

After a credit has been granted business counselling is only done on an ad hoc basis, and at the request of the client. Regular visits are made, but they are not very frequent.

Future orientation is that ICOF increases non-financial services but for intermediate organisations rather than direct to entrepreneurs. It aims to become a service organisation for the social economy, working through local authorities. One of the main services it will offer is the organisation of all back office services for other fund raising and financing organisations.

## Benchmarking case-study

### Women World Banking, Spain

Madrid, Spain

*Date of visit:*

*Executed by Claire Whyley, PFRC and Jan Evers, IFF*

#### Objectives and vision

Women World Banking in Spain has three main objectives, these are to:

- help women into business
- help women negotiate with banks and gain access to favourable credit services
- change attitudes to women within the banking culture in Spain.

#### Short history

WWB was founded in 1989 by Inger Berggren. The original idea was to bring the international network of Women World Banking into Spain. The basis of Women World Banking is that an international collateral network provides 50% collateral for women to start-up a business, while the national branch provides a further 25% and a co-operating bank provide the remaining 25%.

However, this framework was not appropriate in Spain as there were no resources to provide the 25% collateral at the national level, as the policy of the head office changed and because issuing credit in Spain can only take place within the legal framework of a formal bank. Consequently, WWB Spain developed a different system. They negotiated with Caja Madrid, one of the largest saving banks in Spain, who agreed to provide loans for women referred from WWB.

WWB, therefore, works as an intermediary to raise the quality of start up and growth projects for the bank and also helps women, who are not generally viewed as potential entrepreneurs within traditional banking culture, to gain access to credit. However, WWB can only help women obtain loans if they meet one essential criteria – they have to have access to the necessary collateral to support their loan. This generally takes the form of a partner's salary or their property.

Once the co-operation between WWB and Caja Madrid had proved successful, the arrangement was extended to five further bank partners. In addition, in 1991

WWB Spain returned to the lending model used by WWB International to try and overcome the exclusion of women without collateral. They developed a package whereby loans would be guaranteed jointly by WWB in New York and Caja Madrid so that women could gain access to credit without providing their own guarantees. In reality, however, the process of making loans in this way proved too time-consuming, taking several months to put the files together and get all sides to agree. As a result, WWB and Caja Madrid decided to abandon that model and, instead, now deliver some loans without any collateral at all.

In 1998 the Ministry of Labour in Spain agreed to finance *Credit Solidiare* - a group-lending model organised by WWB Spain. The Ministry provides 1 million Pesetas (XY Euro) per woman for groups of up to five women. Although this was a very positive step it was, to a degree, quite problematic. First, because the Ministry refused to provide WWB Spain with any capital to cover their transaction costs. Consequently, the scheme can only be run at a loss to WWB Spain. In addition, the Ministry was only prepared to provide funding for initiatives operating in rural areas. As a result the scheme was first introduced in Guadalajara, where demand was very low and where WWB Spain did not have a local infrastructure. Due to the absence of interested clients the group-lending scheme began with only 3 groups and did not conform to the traditional model. In effect, loans were made to individuals who were then organised into groups retrospectively. The women did not, in fact, know each other in advance of the scheme.

In 1999, however, WWB Spain plans to introduce the group-lending model to Segovia where they already have a local office and network, have secured funding to cover transaction costs, have been able to promote the scheme more widely and also have a co-operating bank which has agreed to leverage the deposit 1:2 into credit capital.

## Organisational structure

WWB is represented in four cities in Spain and is affiliated with the international WWB organisation, which has its head office in New York and networks in fifty countries worldwide. WWB Spain is a private foundation headed by a President who leads a Board of Directors. The organisation has 23 employees in total. Seven are loan officers (LOs) and each office has two secretarial/administrative staff. The remaining staff work in WWB's four Trade Houses.

## Market and client profile

WWB has two main markets, first, its lending activities, and second, its sales and promotional work.

WWB has four Trade Houses in Segovia; Madrid and Malaga. The Trade Houses operate as workers' co-operatives, each shop sells crafts and produce made by women from all over Spain. WWB receives 10% commission on these sales. The annual WWB Trade Fair also gives women a chance to sell the goods they produce. Each year, around 40,000-50,000 thousand people attend

the week-long Trade Fair, held in Madrid. The event is sponsored by a consortium of private companies and by public grants (regional, national and European).

While many of the women who are involved with WWB's sales and promotional work are at a very early stage of their entrepreneurial career, the organisation's lending activities target a more advanced client group. WWB arranges finance for women to start-up new businesses and also provides working capital for women running existing businesses. Finance is available in the form of a loan – via five Spanish banks – or public grants.

To gain access to loans, clients have to provide collateral, a detailed business plan with a viable business concept and, crucially, have the self-confidence to promote it to the bank's loan officer<sup>1</sup>. WWB's clients come from a number of groups: young women who have recently completed a university education; women who have trained in a particular business or trade and have worked as employees for several years; and middle aged women returning to the labour market after caring for a family.

According to one of the loan officers, most of the women who are clients of WWB Spain would probably be able to gain access to credit without help. However, they prefer to apply to banks via WWB because they have a higher chance of success and also because these loans carry more favourable terms.

## Facts and figures

1.	Number of loans disbursed* (in co-operation with bank partners) since inception	470 <sup>2</sup>
2.	Amount of loans disbursed* since inception	1,54 billion pts
3.	Average loan amount	3,3 mill pts
4.	Average loan term in months	60
5.	No of employees	
6.	Total number of loans disbursed* (in co-operation with bank partners) in 1998	21
7.	Amount of loans disbursed* in 1998	110.300.000 pts
8.	Loan balance outstanding* for 1998 (31.10.98)	-----
9.	Administrative expenditure for 1998	210.000
10.	Credit losses/Write off's for 1998	2%
11.	Delinquency rate for 1998	0%
11.	Income from clients in 1998	0

<sup>1</sup> According to the loan officer Mercedes XY, interviewed at 19.01.1999

\* WWB Spain does disburse loans only in co-operation with bank partners. See description above. Therefore there are no refinancing costs and there is no outstanding loan balance

<sup>2</sup> In 1996, 64, in 1997 26, and in 1998 21

12.	Re-financing costs*	-----
13.	Estimated rate of survived enterprises (after three years)	50-60% <sup>3</sup>
14.	Number of enterprises started with the assistance of WWB	1853

## Financial services and credit delivery methodology

With the exception of the new *Credit Solidaire* scheme, WWB do not deliver financial services themselves as Spanish law restricts these activities to formal banks. WWB Spain's role, therefore, is as an intermediary between the banks and their clients. They aim to make women more confident, effective and, ultimately, successful in their dealings with banks, of which most have very limited, if any, experience. WWB are also working to change the banks' attitudes to women customers.

WWB's main credit scheme involves helping women to apply for loans from the five banks with whom they have agreements. During their most busy period – March-May – WWB receives enquiries about this service from 200-300 women per month. They are given information about starting and running a business, about applying for a loan and, crucially, the need for collateral, without which WWB cannot help them. For those who are serious about setting up a business, are not put off by the prospect of applying to a bank and have access to collateral, the next stage is to decide which bank to apply to and attend an interview with the bank's loan officer. Often the WWB loan officer will recommend a particular bank, branch or even member of staff for clients to see, because WWB has a particularly good relationship with them and this significantly improves the likelihood of success.

If the outcome of this initial interview with the bank is positive, clients are asked to produce a formal business plan which they do in conjunction with WWB. The business plan must provide a detailed account of the business the applicant intends to set-up or is already running; a cash-flow forecast; an assessment of costs and a suggested repayment schedule. WWB loan officers provide extensive support at this stage of the process, often creating the business plan themselves on the basis of factual information supplied by clients. They also provide a letter of membership, confirming the relationship between the client and WWB.

Loan officers estimate that approximately 40-50% of people who are initially referred to a bank by WWB and who meet the bank's conditions return for assistance with constructing a business plan. Of those who submit a business plan to the bank approximately 90-95% are successful. WWB could not provide figures or estimates of the number of clients who are sent to bank partners. However, on the basis that there are three busy month each year with 200 initial

<sup>3</sup> According to the loan officer Mercedes. Very interesting is the comparison with the survival rate of clients WWB helped to receive public grants (40%) and grants in the European Local Employment Initiative (20%). This figures were estimated by Ms. Berggren, executive-president of WWB Spain who sees in this figures a close relationship (positive correlation) between amount of capital received and survival rate.

contacts, and nine quieter months with 100 initial contacts, and that 25 loans were made in 1998, we can estimate that around 1 in 30 of initial contacts are referred to bank partners.

Loans arranged by WWB are usually not less than 1,000,000 pts and not more than 6,000,000 pts. There are several advantages to clients of arranging their loans through WWB:

- lower interest rates than for loans organised directly (spread of 2%)
- a longer repayment period
- a 'grace' period of 1-2 years before repayments must be made
- support in creating a feasible project
- access to grants.

Once clients have received and repayed a loan through WWB, they are generally successful in making direct applications to banks for subsequent loans.

In addition to these loans, WWB also offers an Urgent Credit scheme through Banco Popular Espanol. This is to provide loans for working capital for WWB clients to help them cope with emergency situations. Once the application for urgent credit is received by the bank, decisions are made within 24 hours. Loans are up to 5,000,000 pts and carry very high interest rates. Nevertheless, this scheme makes up 10% of all arranged loans.

Until 1998 WWB only made loans to individuals but the *Credit Solidaire* scheme is based on the Grameen Bank in Bangladesh and offers group loans. The scheme was first introduced in Guadalajara and in early 1999 is to be extended to Segovia. To qualify for Credit Solidaire, groups should consist of 5 women. Loans of up to 5,000,000 pts are made, with a maximum of 1,000,000 per person. Loans can be made without collateral, and women do not provide personal guarantees for each other. The groups are intended only to provide social support, particularly for women in rural areas, and members of the groups are not responsible for the repayment of loans by other members of their group.

Finally, WWB also offers VISA credit cards to clients via Banco Popular Espanol, for which it receives 0.05% commission on each transaction. They have issued around 100 cards – mainly with members of their association - so far. Unfortunately, these cards are issues on the basis of a traditional credit worthiness evaluations and, consequently, many clients cannot gain access to them.

## Risk management

WWB does not provide a formal risk management structure apart from preparing the clients to present themselves and their business idea to bank staff and deterring those who are unlikely to be successful.

However, they do reduce the risk faced by new entrepreneurs by offering extensive support during the application process and providing help with developing a business plan. Also the fact that one in two clients return to WWB after the initial bank interview and that nine out of ten receive a loan after they have prepared their application demonstrates that there is an informal but effective selection process. However, this process focuses primarily on the standards of the traditional banks and does not provide an alternative risk-management methodology. This is emphasised by the fact that the initial training of WWBs loan officers was conducted by the bank-partners.

The high repayment rate (98%) with a business survival rate of 50-60% could also indicate that the risk is reduced by a solidarity culture: people repay their loans even if the business fails and they go back into employment. However, it could also indicate that the banks' traditional credit-worthiness evaluation works efficiently in conjunction with a pre-selection and support intermediary such as WWB.

## Loan administration and MIS

Currently WWB is not involved in loan administration and does not operate any kind of management information system (MIS). This is all handled by the bank partners which reduces costs for WWB. However, it also makes it difficult for WWB to evaluate its support and selection process because it does not collect any data on repayment and survival rates.

WWB do issue regular mail-outs requesting information from clients but, unfortunately, the response rate is very low. Collecting the information by telephone is also not feasible due to frequently changing telephone numbers and the often irregular working hours of entrepreneurs.

## Sources of funding and financial sustainability

WWB receives funding for its activities from a number of sources.

- All WWB clients pay an annual membership fee of 10,000 pts. Currently they have around 1.000 clients.
- Anyone who receives help from WWB without being a member is charged an arrangement fee of 10,000 pts.
- WWB receives 10% commission on all sales made via the Trade Houses and Trade Fair.

- The Trade Fair, itself, is financed by a consortium of private and public funders.
- WWB also receives payment (by public bodies) for training courses they offer to individuals who are hoping to set up a business. They normally win these training contracts via a process of competitive tender and are usually successful.
- Finally, their biggest source of income is received from public bodies (local, regional, national and European) for administering and delivering grants and running the trade houses.

WWB are not aiming for financial sustainability and the President of WWB is very clear about their objectives in this area. She firmly believes that micro-lending should not be a profit-making activity. She perceives its primary goals to be social, not commercial. From this perspective, making a profit is merely benefiting from other people's disadvantage and, therefore, immoral. Consequently, the president of WWB perceives the key organisational goal to be convincing the state that more public money should be available to help women set up in business. This is illustrated by the following statements:

*"Whenever there is some additional income we are looking for new social activities to spend it."*

Much of WWB Spain's work seems rely on the president who oversees relationships with the bank-partners and other funding bodies. She also heads the board, consisting out of influential women from a range of sectors. It is crucial, then, that there is another strong person in the organisation who could take over WWB Spain's work should the current president decide to leave.

## Human resources

Currently, WWB Spain employs 23 women. Most of the loan officers are recruited straight from University – five of them are economists and two are lawyers. They are trained by internal staff who originally received training by WWB Spain's bank partners. The salaries paid to loan officers is lower than they would receive in commercial companies and much lower than the traditional banking sector. However, WWB Spain does not seem to have a problem with high staff turnover - only one loan officer has left in recent years. Ms. Berggren sees this as a result of the social commitment of the staff who explained, *"No one would leave to work for a bank"*.

## Co-operation with formal financial services

WWB Spain's lending scheme relies on very close co-operation with formal financial services. WWB Spain's first loan officers were trained by their bank partner and, consequently, their selection and preparation process has developed largely to reflect the decision-making which occurs in the traditional banking sector. They are currently working in partnership with five formal banks.

At the initial stage WWB Spain provides basic, factual information to women about how to set up a business, the financial support available through the banking network and how to go about obtaining it. Women who do not have a viable business idea or who would not qualify for a loan are 'weeded out' at this first stage and WWB Spain concentrates its practical support on those who move on to the second stage. At this stage, WWB Spain helps women to make a good case for themselves at the bank by educating and coaching them in the areas that the banks require. Finally, they assist in the production of a business plan which is also designed to conform with the banks' requirements.

### **Non-financial services**

Although WWB Spain's primary function is micro-lending, the majority of their activities relate to non-financial services. This is largely because they are not permitted, by law, to make loans themselves and also because it is very difficult for them to gain funding to cover their running costs. Consequently, fund-raising is an important element of their work. WWB Spain's main non-financial activities relate to their trade houses and the annual trade fair. However, they also offer an advice and training service funded by public grants at local, regional, national and European level.

## Benchmarking case-study

# Working Capital, USA

Boston, USA

*Date of visit: February 4 - 5, 1999*

*Undertaken by Elaine Kempson, PFRC, Jan Evers and Stefanie Jack, IFF*

### Objectives and vision

The overall objective of Working Capital is to increase the economic success of self-employed individuals and their communities by providing loans, business education and networking opportunities to entrepreneurs with limited resources (Working Capital Directory, 1998).

the organisation operates through peer group lending, with group members providing advice and practical assistance to one another as well as reviewing and approving one another's loan applications. Only around half of members have a loan outstanding at any one time.

### Brief history

Working Capital was founded by Jeffrey Ashe in 1990. The first two peer lending groups were organized in Athol, Massachusetts in September of that year, and the first loans were made in October. Following that initial success, staff from eight local organisations were trained in April 1991 to carry out the program in rural sites in Massachusetts, Vermont and New Hampshire. Initially, Working Capital operated through the Institute for Cooperative Economic Development at New Hampshire College. In 1993, Working Capital was organized as a Massachusetts corporation under the name of Peer Partnership, Inc. It now operates as a tax-exempt, non-profit organisation.

From its initial bases in Massachusetts, New Hampshire and Vermont, Working Capital expanded to Maine, and then to Delaware, Florida, Georgia, Missouri and Rhode Island. It began its first international program in Khabarovsk, Russia in 1997. Currently, Working Capital has affiliates in Massachusetts, Rhode Island, Georgia, Florida and Russia and operates its greater Boston program directly from its head office.

All these programs operate on the same basic philosophy and methodology.

More recently, Working Capital has been selling its methodology and associated handbooks to other organisations wanting to establish micro-lending services in the United States. These organisations have not, however, become part of the Working Capital network and do not trade under the name. The development in this direction

occurred because it was decided to concentrate on strengthening the existing network rather than continuing to expand.

The rapid growth of Working Capital was putting pressures on the head office that was relying on the original founder to carry out a multiplicity of roles. Consequently in January 1998 the organisation hired a new Executive Director, Jim Kaddaras to manage Working Capital. Mr. Kaddaras reorganised the staff and created two new senior management posts: a Director of Finance and Operations and a Director of Development and Public Affairs. The founder became Director of Programs, Innovation and Research. With a new management team established, Working Capital has put in place improved systems for loan management, for fundraising and for the development of the network.

## Organisational structure

Currently, Working Capital has three 'hubs': Florida, Georgia and Russia; It manages its Massachusetts and its Rhode Island program from its head office. Each of the 'hubs' is an independent, self-contained entity although they all operate within the Working Capital model and use the centrally produced handbooks, software and training materials. Florida operates through more than one affiliate and plans eventually to go state wide. In addition to the Central Office in Miami, Florida has three affiliates: in Palm Beach, and Fort Lauderdale;

The Massachusetts/Rhode Island program has six affiliates in addition to the greater Boston program: in Lawrence, Gloucester, Newport, New Bedford, Springfield, and Palmer. (Five inactive affiliates - in Athol, Gardner, Greenfield, Holyoke and Northampton – are being phased out). Boston and Lawrence are the two largest programs. With the exception of the greater Boston program (which is operated from the head office) these affiliates are based in community organisations in each of their respective cities. They raise their own funding and employ their own staff, but the loan capital is provided by Working Capital along with the loan administration. Like the 'hubs' they use the Working Capital handbooks and training materials and all staff in the Massachusetts/Rhode Island affiliates are trained centrally.

## Target group and client profile

From the promotional leaflet:

*Working Capital works best for people who:*

- *Own a small business or have a clear, well-developed idea for a business*
- *Are motivated self-starters*
- *Work well in groups and with others*
- *Are willing to commit to the success of their business*

- *Understand that they get out of Working Capital what they put into it'*

In other words, the organisation accepts as clients both people who have established businesses and those wanting to set one up. But, significantly, those joining the Working Capital program must be attracted to the idea of working in groups as this is an essential part of the philosophy and service. This approach is not attractive to all entrepreneurs. It seems to work best with those in the early stages of establishing a business, for whom practical advice and support from peers is important. It seems more attractive to some ethnic groups than others.

Working Capital is committed to assessing its impact and has commissioned surveys in 1992, 1996 and 1998. At the time of writing the 1998 research had not been published. The following figures, therefore, relate to 1996 and the Working Capital Network as a whole (Anthony, 1996).

Overall, two-thirds of members were white – reflecting Working Capital's initial work in rural New England. In the Miami program, the majority of members were African-American (54%) or Hispanic (33%). Three quarters (73%) of the Delaware program were African-American. Currently in Massachusetts and Rhode Island some two-thirds of the customers are African-American or Hispanic.

The Lawrence affiliate in Massachusetts draws 90% of its members from the Hispanic (and largely Dominican) population.

The majority of members (73%) had at least some college education, with 38% having at least a college degree. As the program has become more urban and non-white, these figures have declined. Seven out of ten were aged between 30 and 49. Younger people accounted for just 7% of members; 22 per cent were people aged over 50. Two thirds were women and 12% were single mothers.

About a quarter lived below the official poverty line<sup>1</sup> and almost one in five were receiving public assistance. These proportions varied slightly across the programmes in different States. Massachusetts had the highest proportion of members who lived below the poverty line – almost four out of ten, and about five times the proportion in the general population of the State. At the other extreme, only one in 20 of Delaware's members were below the poverty line and this was the only State program where there were fewer poor people in the program than in the population as a whole. So, although it was designed specifically for entrepreneurs with limited resources, Working Capital attracts a broad range of people, with 2 out of 10 of its current members in 1996 having annual household incomes above \$30,000 – the median income for most of the States in which it operates.

The majority (78%) of the 1996 members had come to Working Capital with an existing business; 18% had started a business after joining and 4% had never established a business at all. Most were still in business at the time they were

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<sup>1</sup> For example, in 1996 this was \$7,740 a year for a single individual; \$15,600 for a family of four. Currently one third lives below the official poverty line.

surveyed, although the established businesses did rather better (94%) than the start-ups (84%).

Over half of current members in 1996 had applied to a bank for a *personal* loan and 4 out of ten had actually received one. In contrast, fewer than a third had ever applied for a *business* loan and at least 15% did so while they were members of Working Capital. Only 8% were actually given a bank business loan.

Seven out of ten members operated from their own home, but almost a quarter had separate rented premises – shop, office or workshop. Almost half of them had another job as well as running their business; only 16% said their business was their sole source of income.

Due to the following current economic developments Working Capital faces strong competition with regard to client recruitment:

- A decreasing unemployment rate brings more people into jobs. This makes them "bankable" for consumer lending and credit card lending
- Credit card companies have gone "down market" and will lend to anyone with a permanent job
- The concept of micro-lending is becoming very popular in the US and increasingly more institutions provide similar services to Working Capital
- The peer group methodology requires personal motivation and enthusiasm. It does not necessarily require good business skills or a well developed business activity. This makes peer group lending attractive for excluded groups. Under the current positive economic climate, this group has become smaller in size and is concentrated mainly in ethnic groups.<sup>2</sup>

### Facts and figures (head office numbers)

1.	Number of loans disbursed since inception	3.000
2.	Amount of loans disbursed since inception	USD 3.000.000
3.	Average loan amount	USD 1.620*
4.	Average loan term in months	9 months
5.	No of employees	12

<sup>2</sup> As Mr. Ashe, the founder of Working Capital commented: "in a recession the market is better for us" The loan officer in Lawrence said: "they have to be in a desperate situation to be interested in our loans ... if you have a full time job, you can get a credit card credit and you have no time for our intensive group programme".

6.	Total number of loans disbursed in 1998	270
7.	Amount of loans disbursed in 1998	USD 365.460
8.	Loan balance outstanding for 1998 (31.10.98)	USD 351.471
9.	Administrative expenditure for 1998	USD 800,000
10.	Credit losses/Write-offs for 1998	28% <sup>3</sup>
11.	Delinquency rate for 1998	13,7 % <sup>4</sup> (90 days overdue)
11.	Income from operations in 1998 (includes customer income, affiliate fees and training)	USD 175,000
12.	Re-financing costs	
13.	Estimated rate of survived enterprises (after three years)	90%

\* Last quarter of 1998. (Note figures are not currently collected by Working Capital national for the programs outside Massachusetts)

## Financial services and credit delivery methodology

### Client recruitment

Within the Boston and Lawrence areas (the 2 programs visited and the largest in the network) marketing is fairly wide. Public information meetings are held regularly (twice a month in the Boston program) and these are publicised through the media, leaflets and posters. In addition, in Boston, African-American and Latino outreach workers visit Churches and other community organisations to encourage them to host an information meeting. Groups of 4 to 6 people are set up by individuals who have attended these information meetings and the follow-on member training sessions. They may form a group with others attending the same meeting or with friends and acquaintances – or a mixture of the two. About 50% of the people attending the member training form a group. Those not wanting to set up a group or who are unable to do so can become general, or associate, members. They can use all the support and training services offered by Working Capital, but cannot apply for loans.

<sup>3</sup> Working Capital wrote off a large amount of historical bad debt in 1998. This figure is supposed to be near 5% in the future.

<sup>4</sup> This is declining and is now less than 8%

*Enterprise alliances:* Because it can be difficult to get groups established, Working Capital has just begun experimenting with a new approach to recruitment – *enterprise alliances*. Existing membership organisations will be identified in the community, with a view to setting up within them group lending schemes involving 10 to 20 people. In early 1999 two organisations (of farmers and of artisans) were in the process of setting up an enterprise alliance. Members of both groups and enterprise alliances are self-selecting. They are not vetted by Working Capital staff. The basic idea is to find strong group networks, to identify the informal and formal group leader/ gatekeeper/ power base of the group and use this system as a self-regulating network: The group and its gatekeepers should use their long term experience with group members to evaluate their credit worthiness. They are able to judge better than any banker or loan officer is able to. This should result in a low delinquency rate. Furthermore the incentive of a step loan methodology results in a larger loan portfolio.

Once established, groups elect someone to chair meetings and a treasurer who will collect loan repayments and pass them to Working Capital. They then meet twice a month to set working through the Working Capital member manual, business curriculum and officer handbooks together. This guides them through determining the by-laws of the group, the loan application process, how to produce a cash flow statement and a business plan to accompany loan applications, how to make decisions regarding group members loan applications and dealing with late payments. Separate officer handbooks provide guidance for the group treasurer, chair and other officers. This usually takes about 6 to 8 meetings in total, but can be longer if the group cannot reach unanimous agreement on the by-laws.

### **Current Products and plans for future products**

The current product is a stepped loan to individuals in groups, and subject to peer review. Working Capital, Massachusetts, are setting up larger groups, or enterprise alliances, which offer a similar product (see above).

There are no plans to diversify into other financial products.

### **Credit delivery methodology**

All loan decisions are made entirely by the business loan group. Enterprise alliances will work in essentially the same way, with a loan committee of four to six persons reviewing and approving loan applicants. Members wanting a loan complete a full application form, which encourages them to assess in detail the strengths and weaknesses of their business, whether a loan is the most appropriate way of financing the proposed development of their business and how they could raise the money to pay back the loan if they were unable to keep up the repayments. It also forces them to produce a cash flow statement as well as a short business plan. Once

the form is completed it is given to the other group members who decide whether or not to support the application and if so, whether the applicant should receive the full amount they have applied for. This discussion takes place while the applicant is out of the room. Once an application is agreed it is forwarded to Working Capital for processing.

### **Cost of services**

There are two different fee scales; one for business loan groups and one that will be used for the enterprise alliances.

Business loan group members pay a flat 12% interest on their loans, calculated on a declining balance, plus an average of 4% fees. This interest rate has been set to allow Working Capital to remain competitive against credit unions and credit cards (perceived to be their two main competitors). The prime rate at the time of writing was 8%, with fixed rate bank loans costing 9-11% (generally not available to Working Capital customers). Credit cards charge from 15% to 22% interest.

There is also a fee for membership of Working Capital. In 1999 in the Greater Boston program. This was \$120 a year for a chartered group member and \$100 a year for general members (or respectively \$65 and \$55 for 6 months). The membership fee can be paid on a payment plan or through 'sweat equity'.

Enterprise alliance members will pay 10.9% interest on loans of less than \$10,000; 9.9% for larger loans, plus a 2% origination fee in all cases. These lower rates have been set partly because members are expected to be more established businesses than those in peer groups and partly to encourage greater take-up and an expansion of the loan portfolio.

### **Loan administration and MIS**

In Massachusetts and Rhode Island loans are administered centrally for all the affiliates and the greater Boston program.

Loan cheques are issued twice a month (15<sup>th</sup> and 30<sup>th</sup>) and are sent to the group treasurer. Each group treasurer is issued with coupons setting out the monthly loan repayments for each group member, with a new set of coupons issued each time a new loan is taken out or an existing loan is repaid prematurely. At the group's monthly meeting the treasurer collects the loan repayments from the members who have loans. These are then paid into the group's bank account and one cheque sent to Working Capital for the total sum due, along with one of the coupons, setting out how much was due from each borrowing member and noting any under-payments.

At Working Capital's office all payments are recorded on a loan database set up using dBase. A new system was being introduced in early 1999, which uses Microsoft Access and also collects and provides more management information than the one in use since Working Capital was set up. The new system is custom-

designed by a consultant and the loans administrator. (For reasons of prudence, both systems will be used parallel for a period)

A monthly listing is produced of all loans, by group. This is used to identify which loans are overdue or underpaid.

Borrowers are allowed to make over-payments but they have to check before the final payment is made to see how much is due. There is no automatic system for dealing with over-payments and they have to be handled individually by the loans administrator.

## **Risk management**

### **Credit worthiness assessment**

All assessments of creditworthiness are made by peer group members. They are given guidance on how best to determine this in the member handbook. This includes assessing

- the character of the applicant: whether they are capable; committed to their business and the group; trustworthy.
- the feasibility of the business plan and the business.
- the applicant's contingency plans for paying the loan.

Group members have a loan decision form to guide them in their decision-making, which is done while the applicant is out of the room.

Like many other micro-lenders Working Capital operates a policy of stepped loans. The first loan for a new borrower in a group is \$500 (although established businesses can start at \$1,000). Successive loans increase in steps to a maximum of \$10,000, provided previous loans have been paid on time. The steps are:

- \$500 repayable over 4-6 months
- \$1,000, repayable over 4-12 months
- \$2,000 repayable over 4-18 months
- \$4,000 repayable over 4-24 months
- \$6,000 repayable over 4-36 months
- \$10,000 repayable over 4-36 months

Enterprise alliance members will be eligible for larger loans starting with a loan of up to \$2,000 repayable over 4-18 months and increasing to \$20,000 which can be repaid in 4-48 months.

## Ensuring payment

Prompt payment is ensured by peer pressure from other group members. No further loans are given to the group until all members are up-to-date with repayments. Members are not, however, liable for one another's loans. But groups do operate a 'buffer fund' into which members must pay 10% of their loan. This can be used by the group in cases of default.

In addition, charges are made for loans in default. There is a \$10 charge for each cheque that is bounced; a \$10 charge when a repayment is 15 days late and \$1 a day thereafter.

Repayment is also ensured by registering all loans with the credit reference bureau, so any default would affect the borrower's credit history. This is an especially powerful sanction in the United States where 'having a good credit history' is a matter of some importance to all individuals.

Finally, members who are delinquent on any loan payment may not proceed to the next step up in loan amount until they have repaid one loan with no late payments at all.

## Covering losses (Collateral or security)

As noted above, each group has a buffer fund. In addition to the buffer fund, to ensure access to further loans the group could theoretically cover the outstanding debt of a failing group member. However, in practice it seems as though generally all members pay back or fail to do so as a group and consequently no one is ever able to cover the losses of group partners. No other collateral or security is required for loans.

## Debt recovery

In 1998, the debt recovery system was tightened up to reduce the level of default. Currently, a reminder letter is sent to the group treasurer and to the borrower when the loan repayment is 15 days late. If payment is still overdue this is followed by two further letters when the loan is 30 days and 60 days late. None of these is worded especially strongly – the intention being that the group should work out with the defaulting borrower how the money owed is to be repaid. If the group can produce an action plan that is approved by the Working Capital loan review committee (comprising both programs and operations representatives) then loan sanctions against the group may be lifted following successful completion of the plan.

If payment is still not made, the debt is handed over to a commercial collection agency retained in 1998, that is paid 29% of the money recovered. It is too early to say how successful this approach will be. If this fails legal proceedings are started – usually when the loan is 120 days late. In Massachusetts, the borrower may be taken to the Small Claims Court if the loan is less than \$2,000, otherwise a civil

action has to be taken. Working Capital is, however, reluctant to initiate full-blown legal proceedings because of the costs involved.

### **Sources of funding and operational financial sustainability (including transaction costs)**

In the fiscal year 1998, the total income of Working Capital was \$930,000. The largest proportion of this (70%) was in the form of grants from private foundations, government and corporations (including banks). About a 15% of the income came from training and affiliation fees paid by organisations buying the Working Capital franchised services. Fees and earned interest charges accounted for about 7% of income. About 7% of income in 1998 came from unearned investment interest and dividends.

A Community Development Finance Institutions Fund (CDFI) award of \$800,000 has just been made to Working Capital. This provides \$400,000 towards operating costs, \$100,000 for technical assistance and \$300,000 loan capital at 1% interest due 2007. The recent appointment of a Director of Development and Public Affairs has led to the development of a fundraising strategy for both corporate and individual donors.

Transaction costs are currently running more than \$2 for every \$1 borrowed. It is hoped that this will fall when the enterprise alliances are set up as these will offer larger loans.

In other words, Working Capital are working towards greater operating efficiency but accept that they will almost certainly never become fully self-sustainable financially, with their current lines of business.

Our research group estimates the sustainability rate in 1998 only between 0-10% due to high bad debt write-offs. In 1999 with a better loan portfolio and some success with the enterprise alliance scheme the sustainability rate could increase to 20-30%. The potential for sustainability under the current WC strategy is seen at 40%, due to the strong support package delivered by WC and a highly disadvantaged client group.

### **Co-operation with formal financial sector**

BankBoston is a major supporter of Working Capital. In addition, this bank is prepared to look favourably on loan applications from Working Capital members although a credit check will be undertaken. A new arrangement has recently been set up with the Cambridge Savings Bank, which will match \$ for \$ any loan given to a Working Capital member living in their service area without a credit check, after the member has repaid two Working Capital loans.

Another recent development has been a 'bank links' breakfast meeting to assist in forging closer links with banks.

## **Non-financial services such as Business Advisory Services (BAS)**

One of the strengths of Working Capital is the practical help and support that membership brings. In addition to being able to access loans, members are provided with a wide range of other non-financial services, including:

- Advice and support from their loan group members
- Practical help with cash flow management and business planning through the members self-help handbooks
- Access to free legal advice from a local law firm
- The opportunity to build a credit history
- The opportunity to network with other members of Working Capital through meetings, seminars, special fairs and exhibitions
- Listing in the annual directory of members, which is circulated widely and should lead to additional customers

Interviews with borrowers indicate that for those just setting up a business, these non-financial services are more important to them than the loans.