Desjardins
Développement international

SOUND CREDIT PRACTICES: A KEY ELEMENT FOR COMMUNITY FINANCE INSTITUTION SUSTAINABILITY

BACKGROUND

Over a period of several years, DID partners have tested numerous credit products and various delivery strategies. Based on this experience, DID has retained a number of guiding principles. These convictions acquired over the years serve as guidelines for outlining the strategies used and the products offered, especially products aimed at vulnerable populations.

DID is therefore proposing certain guidelines concerning credit which will contribute through their application to achieving the following objectives:

- Fostering access to financial services, especially credit, for the vulnerable.
- Making optimum use of the savings capacity of targeted communities and thus providing true financial intermediation.
- Reaching a level of financial and organizational sustainability in delivering financial services.
- Empowering communities.

WHY BORROW? (THE CLIENT'S POINT OF VIEW)

Towards the end of the 1990s, the popularity of microcredit drew attention to the importance of financial leverage for community development. Suddenly, there was great interest in the impact, methods and strategies put into place by microcredit operators who were promoting the fact that clients who are poor could use credit as leverage to improve their living conditions.

Community finance, and microcredit as a result, became one of the sectors prioritized by donor agencies as a means to fight poverty. It is recognized now that lending to the vulnerable can:

- increase empowerment;
- increase the income and improve the well-being of its beneficiaries;
- help beneficiaries acquire goods and services impossible to acquire otherwise (education, transport, housing).

As a result, in addition to helping people rise out of poverty, access to credit stimulates local economic development and therefore alleviates the burden on the State which would otherwise be required to provide for them.

Access to financial resources is considered a key element in reducing poverty since it offers clients a chance to become financially autonomous through entrepreneurship (in the specific case of productive credit), and earn a stable income during difficult times. Access to credit reduces the vulnerability of clients who are poor and helps them improve their living conditions.

WHY CREDIT? (THE INSTITUTIONAL POINT OF VIEW)

Credit stands at the core of a community finance institution. Its importance stems from the fact that credit generates most of an institution's income through the interest paid by borrowers. This income serves to cover most of the operating costs of a financial institution. Credit enables the institution to generate profits that will ensure viability, growth, and adequate capitalization. Community finance institutions which limit themselves to mobilizing deposits simply to protect the funds only achieve part of their economic mission if most of the savings deposits are banked.

In addition to depriving themselves of a major source of income, simply banking the deposits does not procure for the community any of the benefits resulting from financial intermediation.

The data in Figure 1, taken from various networks of DID partners, demonstrates the importance of interest income for community finance institutions. Interest income from lending activities represents from 61% to 86% of total income according to the partner. Regardless of the level of savings deposits converted into loans, interest income constitutes the largest type of income. For example, *Network A* which converts 95% of savings deposits into loans is able to cover operating expenses and obtain a positive adjusted return on assets (AROA). In contrast, *Network C*, which only distributes 54% of savings deposits into loans, cannot cover operating expenses and has a negative return of 38%.

Figure 1: Credit/deposits and operating self-sufficiency

	Network A	Network B	Network C
Credit / total assets	65%	47%	40%
Credit as percentage of savings	95%	70%	54%
Interest income / total income	70%	86%	61%
Adjusted return on assets	4.2%	-0.7%	-38%
Operating self-sufficiency	140 %	96%	18%

Credit ensures the viability of an institution but can endanger it because it also represents the main business risk of the financial institution. Figure 2 shows a marked gap in terms of profitability between an institution with sound management of its portfolio (*Network A*: 90-day PAR of 2%) and a different institution whose credit management is clearly deficient (*Network B*: 90-day PAR of 35%). For institutions practicing true financial intermediation, control of PAR means maintaining control of equity while for cooperatives, its means maintaining democratic control.

Figure 2: Quality of the portfolio and profitability

	Network A	Network D
Credit as percentage of savings	95%	85%
90-day PAR	2%	35%
Adjusted return on assets	4.2%	-21%
Operating self-sufficiency Capitalization	140% 19%	62% 7%

Credit consequently disperses the assets of the institution into the hands of a multitude of borrowers. This situation makes management of the credit function highly complex and occasionally very risky. That is why it is necessary to resort to ways of working and tools that can reduce the risk linked to credit and make this activity profitable.

CREDIT FOR WHOM AND FOR WHAT PURPOSE?

Target clientele and product development of adapted credit products

DID encourages access to credit for the vulnerable, without restriction to certain categories of clients or exclusion of specific segments, while supporting product development that is adapted to a variety of clienteles.

The clientele targeted for community finance is characterized by its inability to obtain access to financial services from the formal sector. In most cases, this refers to operators in the informal sector or consumers who cannot meet the requirements of the traditional financial system. The traditional system generally sets conditions that limit or make access to financial services impossible for the vulnerable. In many cases, those seeking to create their own job are already engaged in productive activities and enjoy a minimum income.

Women constitute a large share of those excluded from the traditional banking system. They represent great potential for the creation of self-sustaining jobs. Women also make up the majority of the poor on every continent.

For DID, credit products are not designed exclusively for the poorest, since the institutions already in operation must continue to offer these services to their clients, even if these clients no longer meet the criteria of strict poverty. Those who, through their own efforts and by borrowing, have succeeded in rising out of poverty must continue to have access to these services. Even after crossing this first threshold they still do not have access to services provided by traditional financial institutions. Once the business relationship has been established, it is advantageous to maintain it and it would be economically irrational to do otherwise. The profitability of these clients lifted out of poverty makes it possible to continue providing the vulnerable with access to financial services.

On the other hand, based on the fact that DID encourages accessibility through the development of community finance institutions, these institutions must remain open to the community as a whole.

Moreover, due to the low population density in certain countries, the institutions must diversify their activities in order to create the critical mass needed for profitability. In order to reach profitability, these institutions must offer services not only to the poorest but also to other categories of the population that do not have access to financial services, and also without creating new excluded clientele. In fact, the search for sustainability must not cause the institution to drift away from its original mission by excluding or marginalizing part of the population.

Entry to the more traditional financial system

The main goal of community finance is to reach a clientele that is not served by the traditional financial system, due to lack of resources or guarantees. The aim is to include these clients in an alternative system of financial intermediation in order to progressively improve their economic circumstances and lead them towards products that could be labeled as traditional.

Moreover, the institution must take part in the social and economic development of its zone or intervention area. It must promote the integration of community finance institutions into the formal financial system. The history of the Desjardins Group has developed in this manner. Desjardins learned to adapt to the economic conditions of its clientele and meet their ever growing and changing needs. At first, Desjardins was not part of the formal system. What would have been the future for Desjardins if its vision had been directed only towards encouraging accessibility for the vulnerable?

Categorizing credit products and targeting clienteles

DID uses four key concepts to distinguish the types of credit products related to the clientele it is aiming at and embraces a principle of progressiveness. As a result, DID categorizes various credit products by using the terms entry products, products with coaching, integrated products and formalization products.

The principle of progressiveness

Since confidence is the foundation of any business relationship, it is essential to build the relationship by minimizing risk right from the start. Clients will be able to take advantage of community finance services gradually in terms of both loan amounts and the terms and conditions involved. The clientele targeted does not generally have a sound and reliable credit background that would reassure a potential lender. In fact, it is necessary to set up mechanisms to help borrowers build a credit history as their economic activities develop that will enable them to qualify eventually for bigger loans that are less costly for themselves and for the institution. This principle of progressiveness may apply within an organization in terms of the products offered or within a single product. The product offered should be designed to reach a specific clientele as best as possible.

In light of this, in **Figure 3** DID presents four categories of products large enough to cover the full spectrum of credit products offered, along with their characteristics.

This simplified chart is useful for understanding the differences between each category of products and the type of clientele targeted. Any credit product could be presented as a variation of one of the four following categories:

Figure 3: Credit product categories

Types of Products	Entry	Coached	Integrated	Formalization
Borrower history	-	-/+	+	++
Guarantees	Non conventional -	-/+	+/-	Traditional +
Deposits as collateral (blocked)	-	-/+	+	+/-
Systematic savings deposits (obligatory)	-	+	+	+/-
Distribution methodology	Group	Group or Individual	Individual	Individual
Amounts	●	●	●	●
Frequency (depends on loan use)	+	+	+/-	+/-
Term	Very short term ●	●	●	Long term ●
Cost (tarification)	+	+	+/-	-
Target clientele	▪ vulnerable individuals ▪ groups with strong ties ▪ sparsely populated zones	▪ individuals or groups ▪ clientele that has improved its financial situation using entry products	▪ individuals or enterprises known by the institution ▪ merchants and entrepreneurs in the informal sector	▪ individuals or enterprises known by the institution ▪ merchants and entrepreneurs in the formal sector
Examples of DID partner products	▪ village banks ▪ credit and education ▪ solidarity group (initial cycles)	▪ solidarity group (final cycles) ▪ association for intermediate credit ▪ flash credit	▪ *Biznis* loans ▪ variable loans for market operators ▪ consumer and productive loans guaranteed by systematic deposits and collateral	▪ business loans ▪ salary based loans (paid by paycheque deductions) ▪ mortgage loans ▪ leasing services ▪ Other services (insurance, transfers of funds)

Entry product category

These products are intended to reach the vulnerable. As a rule, they lower entry barriers such as:

- lack of guarantees;
- loan size;
- illiteracy;
- requirements in terms of prior deposits;
- gender-related constraints.

These barriers can be bypassed using group methodologies, having loan officers travel, simplifying and adapting procedures and by the possibility of financing entry fees (such as the membership share and initiation fees). In particular, these products also feature:

- few entry barriers;
- group methodologies;
- small loan amounts;
- high borrowing costs;
- fast repayment schedules;
- short terms.

It is recognized that group methodologies are especially effective with women. However, in certain environments specific cultural characteristics may make peer lending guarantee approaches difficult.

These products, by their design, meet the need to educate clients about banking. Clients are "conditioned" to do business with a financial institution. The products in the entry category will also allow for developing and monitoring a credit history for clients.

Products with coaching category

These products meet two objectives:

1. They ensure continuity by upgrading service for clients who fulfilled and met their commitments involving entry products.
2. They lower entry barriers for a population that is not as vulnerable as the preceding category (entry product category).

These products are intended to coach clients to save in a disciplined manner so that they meet the requirements of the next two categories of products. These products feature:

- systematic savings deposits;
- larger amounts;
- high borrowing costs;
- individual or group methods.

This category is aimed at those whose needs are growing quickly and/or have become too specific for the constraints related to group loans.

Integrated products category

This category of products comes close to what may be termed more traditional products. The expression refers to the integration of these clients who can now meet stricter terms and conditions for lending and collateral. The products in this category feature:

- known credit history;
- lower borrowing costs;
- individual methodology;
- deposits as collateral;
- more conventional guarantees.

As a result the amounts are higher, as are the entry barriers. But at the same time, this type of product is less costly for borrowers.

Formalization category

This last category of products uses the same logic and extends the loan products offered to include those available from institutions considered to be in the formal sector. Products in this category feature:

- known credit history;
- product design tailored to borrower needs (term, amount, repayment schedule) without however involving terms and conditions that would increase institutional credit risk by, for example, granting a loan that has no repayment of capital or interest for a year. A regular minimum payment (such as a monthly interest payment) must be planned. In this manner contact is maintained with the client regardless of the type of product;
- sound guarantees;
- low cost for borrowers;
- individual methodology.

In this category, the product offered has no other limit than the institution's capacity and should therefore meet all prudential management ratios (maximum loan to a member, matching, etc...)

Gradually tailored

These categories simply provide a descriptive background for the credit products proposed by DID. They are not mutually exclusive, strictly defined entities. By providing services adapted to the profile of the client, DID and its partners can continue to serve those whose needs are changing and growing over time and guarantee access to the largest number of people. It also makes it possible to build client loyalty throughout the relationship using long-term development based on credit history. Gradually tailored credit products may produce increased economies of scale and have a positive influence on innovation. A graduated approach allows for complementary methods for groups and individuals.

DID suggests offering a limited number of credit products, that are attractive and profitable, have been developed using tested methodologies, and are market driven, while respecting all legal requirements in the targeted country.

Product development methods must be systematic, iterative and use a step by step approach. The process must be market led, which implies that partners should constantly ensure that the product meets client needs taking into account the strengths of the institution and its competitive advantages:

In this respect, the product development guidelines developed by Micro-Save Africa available through the Systems and Instrumentation Division provide valuable support at each stage. DID encourages their use both for introducing new products and for revising and improving existing products so that they are always adapted to client needs.

Using credit

DID distinguishes between productive credit and personal loans and recommends adapting the following procedures.

Generally speaking, DID recommends that its partners differentiate their loan portfolios according to the usage stated by borrowers for the amount loaned. The following distinctions can be made:

Personal loans (or consumer credit): Personal loans are used for example to purchase or build a family residence, purchase a refrigerator, to pay for schooling, or cover medical fees, etc. The purpose of the loan is not to generate income. It is to cover an expense and must be paid out of the regular income produced from a source other than the purpose of the loan.

Personal loans may also be used by families to avoid calling on usurers that would destabilize their finances just to cover temporary needs (school fees, death in the family, illness, etc.). Consumer credit may stimulate the local economy by favoring the purchase of goods made locally which can have positive spinoffs for the community, especially when replacing imported goods. Housing, for example, improves the quality of life of the population and sets off a multiplier effect when local materials are purchased and extensive local labour hired. A loan used for housing or renovations is as beneficial for the economy as is productive credit. That is why DID does not exclude consumer loans, if income allows for repayment. However care must be taken to avoid overindebtedness. For this type of loan, client savings habits are often an indication of the ability to repay.

Productive credit (for income generating activities): productive credit can be requested by individuals or by businesses, with the intent of improving production activities, or operations. It may also be used for example to purchase equipment, means of transportation, inputs, to build up stocks or to expand a factory or facility. The aim of this type of investment is to consolidate or increase the profits of the business. Productive credit produces income. This is its most important feature, since the repayment of productive credit is generally supported by income generated by the financed activity.

Income generated by any activity is considered as income from a business. The business may be large or small, individual or collective. In the same manner, individuals working for themselves (farmers, artisans, livestock producers, merchants etc.) are entrepreneurs. The business may be structured in a formal manner or operate in the informal sector. It may be an agricultural, industrial or commercial concern. In this respect, DID believes that setting up a financial centre for entrepreneurs is an appropriate organization strategy to meet the needs of these types of specialized loans.

Credit must be available to micro-entrepreneurs (artisans, freelancers, merchants), as well as to farmers. These are the ones who suffer most from the effects of usury.

DID considers agricultural production units as enterprises, including groups, cooperatives or associated producers such as market-crop cooperatives or production groups. At the same time, DID recognizes that agricultural loans have their own characteristics in terms of risk and methodology. The challenges linked to risks and cost of analysis, following up on and collecting repayment of farm loans require different types of business solutions, as well as in-depth understanding of the agricultural marketing systems to be financed. Production capacity is the basis for agricultural loans, which implies other essential factors which must be taken into consideration. In this respect, DID has a specific policy for agriculture addressing the nuances and specific features of this sector.[1]

[1] See DID Agricultural position paper.

WHO ARE THE LENDERS?

Resources involved in the lending process

DID encourages hiring resources dedicated to credit management from the moment the institution is set up.

DID has learned from experience that it is necessary to rely on dedicated resources with specific expertise in lending. The personnel must know the principles involved in financial intermediation and business development.

Therefore, it is recommended that right from the startup of an institution, loan officers should be brought on who will be in contact with borrowers and in charge of granting and following up on loans within the base institutions themselves. The management of these resources may be centralized in a credit service or decentralized among the base institutions. DID recognizes that calling on specialized human resources for credit may prove difficult, even impossible in some environments. Expertise in lending is largely built up over time and is based on a strong ability for analysis and good judgment. The notion of structured training in conjunction with extensive coaching becomes essential to ensure that the resources have mastered the concepts of credit management.

DID favours centralization of the management of these resources to facilitate the sharing of resources among the various entities of an institution and ensure better control. In recent years, the creation of financial centres for entrepreneurs by certain DID partners illustrates the desire and the need to group specialized resources together.

Structuring the credit function

DID favours setting up a formal, well structured and centralized credit service within the institutions it supports.

Within an institution constituted as a network, base entities will be responsible for the quality of their portfolio while the apex entity will provide support through its supervisory and surveillance role.

DID encourages creation of a formal credit service within its partner institutions, whether they are set up as networks or not. In the case of an institution not affiliated with a network, centralization will refer to a formal unit at the head office. The following responsibilities are centralized:

1. Defining standards and the credit policy.
2. Setting interest rates.
3. Recommendations on user fees for products and services.
4. Development and implementation of work tools (forms, questionnaires, etc.).
5. Adaptation of transaction systems and management of credit policies, products and procedures.
6. Determining the limits of lending authority delegated to base institutions and their staff.
7. Authorization of loans exceeding the credit amount or the risk delegated to base institutions and their staff. (the right to review decisions).
8. Training of staff and board members of base entities in addition to technical advice and support.
9. Special assistance for activating guarantees.
10. Compilation and processing of data from base institutions using the data supplied by the transactional and management information systems. Data may also be used for sectoral analyses that can be used for benchmarking financial statements from borrowers.
11. Reports to board members of any irregularities uncovered involving credit management.

This service (located in the apex entity in the case of an institution constituted as a network) authorizes loans exceeding the delegation of lending authority to the base entities, provides them with support and training services and is in charge of adopting standards applicable to affiliated entities for their joint and individual interests.

Lending approval methods

In the case of a cooperative institution, the power to lend belongs to the base entities. However, to ensure the security of the institution, DID recommends setting up an authorization process including the delegation of lending authority to base entities using a variety of criteria. DID also believes that above a certain level, credit committees set up among partners with the status of cooperatives must have a consulting role and base their recommendations on analyses performed by experts.

DID believes that all community finance institutions must equip themselves with a sound lending process that is independent of the marketing function, in order to ensure that credit risks are analyzed and reviewed adequately.

With the aim of maintaining a flexible and community-based service and to depersonalize the authorization process, DID recommends delegating authority to lend to the base institutions and their staff. The authorization process must recognize the level of competency and responsibility of each of those involved and must be reflected in a multi-level decision-making process. In practice, larger loans call for more levels of decision making for sound results. The limits of authority set the path for a loan request before it is approved. These limits vary among institutions according to size, variation in the quality of portfolio management and the degree of skill of the human resources. Base entities remain ultimately responsible for the quality and management of loans they make. In institutions constituted as networks, security of the network must take priority over the autonomy of any of its components.

Delegation of authority will depend on the managers' loan portfolio management history. For, example, two identical institutions could delegate different levels of authority to lend to their managers and employees based on their abilities and professional aptitudes. A performance monitoring system must be instituted for each individual with authority to lend. This delegation of authority to lend must be reviewed regularly and systematically.

The level of delegation will depend on the complexity of the loan applications, the amounts, the expertise and experience of the employees, the type of loan and the sector of activity. However, authority should not be limited to just the amount, but also to the number of loans and the sector of activity.

Among partners with the status of cooperatives, credit committees, in institutions where they exist, should play a consultative role (as a credit bureau) for loans beyond the authority delegated to them, due to their knowledge of the borrowers.

At the same time, the collection function is a specialization in itself and collection techniques must be systematic and proportioned to their anticipated impact. Intervention by board members must be highly supervised and limited to specific actions.

Lending to board members and employees

Loans to board members and employees must be subject to much stricter procedures in terms of analysis, monitoring and divulgation.

Loans to board members and employees must be subject to specific procedures and be automatically directed to a special committee for authorization. This is required for control and to diminish possibility of collusion or fraud

Employees and board members of the institution may borrow on the same basis as regular clients and loan approval should be done using the same criteria.

All loan requests from board members must have prior recommendation from a loan officer and be authorized by the special committee in charge of these applications. In no case may employees or board members benefit from advantages of any kind in loan terms and conditions or decisions in relation to the regular clients of the institution. The credibility of the institution is at stake.

In addition, loans made to board members and employees, and to related individuals must be identified as such, reported and be subject to systematic and strict control.

HOW IS LENDING ORGANIZED?

Development of a credit policy and related tools

DID favours the development of a credit policy that is formalized and shared by its partners.

Since the loan portfolio represents the main productive asset of a community financial institution, management of credit risk has proven to be a key factor in performance. Credit risk and the risk of financial loss result from the inability of borrowers to completely fulfill their financial obligations, for whatever reason, in relation to the institution. Therefore it is necessary to put into place a credit policy whose application will provide security for the assets of the institution.

The policy is intended to define the loan management principles that must be respected by the board members and employees of the institution. The profitability of the portfolio is the prime factor ensuring the profitability and permanence of the institution. The credit policy must be designed in a manner to minimize the risks of loss.

More specifically, the objectives set out in the credit policy must be as follows:

- provide security for the loan portfolio;
- minimize losses on loans;
- make productive assets profitable;
- establish policies and principles for loan approval and collection;
- make loans that are in the interest of the institution, its clients and members (or shareholders);
- ensure the long-term sustainability of the institution.

In order to properly supervise lending activities, DID recommends drafting an official policy. Minimum content should include:

1. standards dealing with:
   a. limits on the loan portfolio in relation to mobilized savings deposits (commitment coefficient);
   b. limits on the loan portfolio in relation to assets;
   c. limits on the loan portfolio in relation to loans to a single borrower;
   d. limits on the loan portfolio for employees and board members (including interested parties or related individuals).
2. eligibility criteria for credit.
3. general characteristics of credit products.
4. types de loans authorized (consumer and productive).
5. the approved terms and conditions for repayment.
6. method for establishing interest rates.
7. application and analysis fees (indicating who must pay fees).
8. penalties for late payment (default interest).
9. types of acceptable guarantees and conditions.
10. repayment terms and conditions (including prepayments).
11. exceptions from the credit policy.
12. conditions for loan rescheduling, extension or renegotiation.
13. rules for delegation of authority to lend.
14. different levels of responsibility (salaried workers, managers, board of directors and credit committees in base and apex institutions).
15. rules for monitoring loan files.
16. principles for loan collection.
17. legal recourse in case of non-repayment.
18. rules on reserves for doubtful loans and write-offs.
19. mechanisms for monitoring of credit management by the apex structure.
20. possible derogations from the credit policy.
21. conditions for reviewing the credit policy.
22. signatures and date the policy is effective.

It is suggested that the DID credit policy model be consulted. It is available on request from the Systems and Instrumentation Division.

A credit procedures manual must explain in detail all the activities linked to credit (analysis, recommendation, authorization, contracts and guarantees, monitoring, collection, legal measures).

As an appendix to the credit manual, the institution should present a description of its credit products (information sheet format), and its rate grid, as determined and authorized by the board of directors.

Finally, the delegation of authority to lend must be detailed and set down in writing, for all those authorized to approve loans. It must also be updated systematically and periodically.

Loan approval analysis and criteria

In all instances, DID has established that analysis and the decision to lend should be based on the following criteria: ability to repay (current and future), capital (net value), character, conditions and guarantees

Credit in the context of community finance is still a commercial activity. It is relatively easy to solicit client borrowing, although it can prove extremely difficult to recover the amounts lent out. It should be noted that the effort required to compensate for the loss of income caused by bad loans is considerable. In consequence, it is better to refuse a good loan than to approve a bad loan. From the outset, DID disapprove that a loan be based on a multiple of the client's savings deposits.

Also, the effectiveness of credit activities is an essential condition for profitability. The costs of reaching profitability must be minimized. Key elements are productivity and volume. Simplicity and rapidity must characterize management and decision making.

DID makes use of the 5Cs of credit:

- **Capacity:** approving credit must be based on analysis of borrowers' current and future ability to repay and their financial capacity to support the requested loan. An analysis of the cash flow generated by the business as well as the household is necessary. A demonstration of the capacity for repayment is an essential condition for granting a loan. If the capacity for repayment is low, additional guarantees are not the solution. Establishing indicators of the capacity for repayment, is often quite uncertain, especially in less known or informal economic sectors. As a result, approving a loan may be conditional on the **demonstration of the borrower's capacity to save**, which is much easier to establish, although loan approval is somewhat slower.

  The most reliable evaluation technique for borrower capacity is certainly an on-site visit by the loan officer, in order to validate and ascertain the accuracy of the information provided. **DID systematically recommends visits for all integrated and formalization products**.

- **Character**: this criterion refers to the integrity and honesty of borrowers. It attempts to evaluate their character, their savings and borrowing habits and reputation. In the context of community finance, assessment of character is often the only evaluation criterion that is available or useful, especially for entry or products with coaching which use group methodologies and peer lending guarantees.

- **Capital**: analysis of capital provides information on net value, liquidity and the structure of the client's assets and liabilities. This also represents what could be offered as collateral for repayment. An in-depth study of the capital, provides information on client capacity to manage assets and incomes. It also provides information on the capacity to handle the unexpected.

- **Conditions and knowledge of the sector:** it is essential to understand the operating environment of the business, in order to propose an adapted credit product (amount, term, repayment schedule as a function of cash flow from the business or project).

  Evaluation of the level of competition, the size of the client's business and potential external threats may play a major role in making the decision.

  Since loan officers cannot have all the expertise needed to analyze every sector of activity, it is recommended that the institution, through its credit sector, produce data sheets for the main sectors of activity in which loan officers are working. Data sheets will allow them to quickly become familiar with a sector, the investment required, costs for operations and equipment, cash flow, etc. Data sheets serve as references for loan officers who will be able to validate, measure the practicality of the proposal and, after the loan is made, undertake close follow-up for the loan and the sector of activity.

- **Collateral (guarantees):** there is no single solution for guarantees. The best guarantee is still reassurance of a borrower’s desire to make repayment (character). Priority is placed on the ethics and the reputation of the borrowers. One should also rely on the dissuasive effect that can be produced by loss or degradation of a personal reputation in the community. No additional guarantees can make up for a lack of ability to repay. Accepting collateral only provides additional security for disbursements made by the institution, by placing pressure on borrowers. Collateral guarantees are not an end in themselves, only a way to attenuate risk and offer better interest rates.

The requirements for guarantees vary with the loan requested and its category. Credit provided using entry and coached products requires alternative types of guarantees such as a solidarity guarantee or systematic savings deposits, while credit provided through integrated and formalization products relies on more conventional guarantees. Utilization of various measures can decrease risk. Guarantees are some of these measures. They take various forms and depend mainly on the category of products. On their own, however, they do not eliminate risk.

Nevertheless DID at all times recommends a minimum of blocked savings deposits, except for entry category products. In this way an institution will always obtain a substantial portion of its guarantees from the blocked savings deposits which constitute the type of guarantee the most easily activated in case of default. For products in the formalization category, blocked savings deposits could in part be replaced by more traditional types of guarantees such as fixed assets.

The basis of reimbursement remains the ability to generate excess revenue based on an activity or a salary. It is definitely the main criterion. To minimize the risks of loans made, one must also rely on borrower experience and knowledge as well as on the practicality of the activity and its ability to generate surplus income. An evaluation of the management capacity of entrepreneurs is as important as analyzing the financial statements, which are often not available. Repayment terms and conditions must also be harmonized with the nature of the activities financed. That is why it is important to understand the environment and the operations of the enterprise in its sector of activity. There should be no hesitation in turning down a loan if the sector is not familiar or if the risks are difficult to assess.

Tarification of credit products

In order to withstand the test of time and continue to offer financial services to clients, financial intermediation activities must be based on and managed according to profitability. DID recommends credit product tarification that provides for the profitable operations of its partners and covers the risks incurred. DID also encourages its partners to move towards the practice of modulating risks for borrowers or category of borrowers.

Striving for long-term sustainability of the services offered means respecting market rules and achieving profitability for operations. Interest rates should thus be set in order to provide for operating costs, the cost of obtaining funds (deposits, borrowings) and losses on loans, in addition to obtaining a rate of return designed to remunerate capital and allow the institution to grow. The injection of grants distorts the market and should not be taken into consideration for tarification purposes. In all cases and for each product, tarification should cover the real cost of delivering services. Operating costs obviously include supervision costs incurred by the apex structure and its centralized services (system costs).

Financial profitability is the only path that allows for an increase in the number of operations and their sustainability. Profitability will often be acquired through growth in volume. It should, therefore, be expected that for emerging institutions profitability could take several years, especially to make supervisory services profitable. This fact must be understood from the outset so that institutions in startup phase are not burdened with excessive growth targets.

In community finance, it is well known that interest rates do not constitute a limit on the demand for credit, quite the contrary. With a regulated ceiling on rates, operators may find it difficult to lend to the poorest. The transactions costs are in fact too high, especially in the case of entry and integrated products. Interest rates must of course be set within the competitive context and lack of efficiency does not justify setting high interest rates. Since interest rates must also correspond to the cost of delivery, they differ according to the product delivered.

Tarification of credit products must reflect maximum efficiency of the institution's management (the lowest possible cost). It must not reflect poor management of products and services, which would risk having it lose ground to the competition.

Tarification is established mainly in function of the competition, the risk that the loan represents, administrative and financial fees incurred for management of the product by the institution. It may be expressed in a combination of different types of remuneration such as interest rates, analysis fees, management fees, etc.

Modulation of risks by category of borrower and impact on interest rates

Although each product offered by an institution may have its own tarification, it may be desirable that it be modulated in relation to the borrowers and the risk it represents to the extent that the following conditions are met:

1. Have sufficient information on client credit habits – this knowledge is essential for properly modulating tarification. This may mean having access to a risk clearinghouse or a credit bureau.
2. Be computerized in order to manage a variety of interest rates.

Application of interest rates according to borrower risk or category of borrowers encourages equitable selection of borrowers and professionalizes the credit function. It may motivate clients to properly repay loans in order to obtain lower interest rates on their loans. However, the modulation must be significant to be effective.

DID invites its partners to move towards modulating interest rates for borrowers, especially for products in the formalization category when the proper conditions exist. For products in other categories, it may be preferable to set up a financial incentive that is paid out at the end of the loan. It is in fact at the end of the loan that the risk is known. This approach is effective, transparent and can motivate borrowers. It is a mechanism that is related to systematic savings deposits since the amount will often be used for subsequent loans.

The document entitled Calcul du taux effectif et tarification d'un credit product available in the DID list of tools promotes outlining a suitable product tarification as does the material produced by CGAP dealing with analysis of costs per product and activity, available by request from the Systems and Instrumentation Division.

Interest rate calculation methodologies

For the purpose of transparency and a desire for exactitude, DID encourages the use and posting up by its partners of interest rates calculated using the declining balance method, rather than the flat rate method.

DID believes that interest on loans must be calculated on the remaining balance (declining balance method) rather than on the amount borrowed at disbursement (flat rate method). According to the declining balance method, the posted rate is the actual rate that borrowers will pay on the average balance borrowed which is not the case with the flat rate method.

In the opinion of DID, it is important that partner institutions are fair, and operate in a disciplined and respectful manner. From this viewpoint, clients merit full, accurate and understandable information on the terms and conditions of the products and financial or non-financial services offered, including service fees for borrowing and transactions and the calculation methods used for interest rates. Institutions must be committed to promoting practices that guarantee that their clients can make enlightened decisions and adapt their strategies, policies, procedures and products as a result.

Diversification of the portfolio

DID encourages healthy diversification of the loan portfolios of its partners. Diversification may be undertaken for various categories of loans or clients, the type of loan (consumer and productive), geographic regions or sector of activity.

To properly accomplish their development role, it is in the interest of community finance institutions to serve diversified clienteles (the poor and the less poor), in both rural and urban areas in order to accomplish social intermediation through financial intermediation.

The concentration of a loan portfolio in a particular sector of activity may represent a major risk for an institution. The diversification of the portfolio therefore constitutes an essential element to reduce the overall risk for loans made. It is, therefore, in the interest of the institution to assess the level of risk of the different activities financed, restricting certain sectors of activity and developing others as the case may be, in order to obtain proper weighting of the portfolio in relation to risk. Moreover, the establishment of alarm signal parameters should be envisaged to halt lending when a sector of activity or category of borrowers exceeds a level of delinquency. Implementation of a moratorium could also be imposed in certain situations.

Risk could be shared through diversification by sector of activity, type of product, by geographic sector or by market segment. If diversification proves to be difficult in a given zone due to regional social and economic characteristics, the institution should, as a measure of prudence, be more selective in the quality of its borrowers, in order to avoid a sectoral crisis that could produce major damage.

Another strategy that could be envisaged for diversification involves selling or swapping part of its portfolio with other institutions, in order to avoid overweighting by a given group of borrowers. Although this strategy is more available to mature institutions, similar diversification could be obtained at startup by establishing new financial cooperatives with points of service for different sectors of activity.

Matching funds

From a risk management perspective, DID encourages monitoring and tight management of asset-liability matching for its partners for terms (short, medium and long term), interest rates (fixed and variable) and currencies (local versus foreign).

By acting as financial intermediaries, community finance institutions are exposed to the risk of financial loss resulting from default in maintaining funds to meet financial obligations. To reduce the risk related to liquidity, community finance institutions must be able to forecast and measure cash flow. They must be able to closely control cash inflows and outflows using cash flow budgets and draw up contingency plans. An institution that intends to make long-term loans must be able to rely on sources of funds with similar terms in order to limit its liquidity risk.

Community finance institutions must also protect themselves from the loss that may result from interest rate fluctuations. By lending out mobilized funds, they run the risk of suffering from a change in the interest rate structure on loans in relation to the interest paid on savings deposits (especially term deposits). Strict management to ensure matching the terms for deposits and loans is a necessity.

In the same manner, when an institution offers savings accounts in foreign currency and makes loans in local currency, it runs the risk of financial loss from a variation in exchange rates. DID believes that the institution must develop its matching capacity and set up suitable mechanisms before taking on these types of transactions.

Portfolio follow-up on credit and collection methods

Portfolio follow-up requires strict and rigorous management criteria aimed at preventing situations from getting out of control. DID promotes systematic portfolio monitoring according to a zero tolerance principle based on the notion of portfolio at risk (PAR) and does not adhere to the notion of a grace period or systematic rescheduling.

Although recent, the history of community finance has taught us that profitability problems in community finance institutions are almost always directly linked to delinquency problems. Delinquency inevitably causes situations of losses on loans and additional costs for institutions.

The definition of delinquency and the method of calculating various portfolio quality ratios have always been subject to different interpretations and debate. Nonetheless the information that must be provided to managers should be of the best quality in order to properly inform managers of changes in the loan portfolio status.

The best method for reducing collection efforts consists above all else of making loans according to the credit policy of the institution along with periodic assessment of the policy as the context changes for the various categories of borrowers. Also, it is essential to establish a close tie between the institution and the borrower at the very start. Direct follow-up of borrowers is an important factor in preventing delinquency.

However, despite integral application of the policy and the rules for lending by competent loan officers, a certain level of delinquency in any loan portfolio can be observed. At the opposite extreme, a high rate of delinquency would demonstrate an overly lax application of the loan approval process or in portfolio follow-up.

DID proposes a portfolio follow-up methodology based on the concept of portfolio at risk (PAR). It is generally admitted that a PAR which does not exceed 3% for loans overdue more than 90 days constitutes a criterion of sound management quality for a community finance institution. This ratio must be calculated not just for the portfolio as a whole but also for each product (or product category) of loans and for each loan officer.

In terms of collection, it has been shown that the sooner an intervention is undertaken with borrowers in default, the chances improve for collecting repayment of the loan in full. The procedure and the monitoring tools for accounts in default must therefore strive for and allow for rapid intervention. Rigourous and methodical efforts in applying the collection process (reminders, notices, visits, ultimatums and public announcements) will result in collection of a larger part of the loans, in addition to maintaining the ethical level of the borrowers, by demonstrating that there are serious consequences to not living up to their commitments.

While the zero tolerance principle for late payments is a fundamental principle for lending, cooperatives distinguish themselves by also referring to other concepts such as economic mutual assistance, community involvement and education of their members. However, application of these principles at the collection phase should not affect the profitability of the institution to the point that its survival would be threatened. The development of strategies linked to these principles must be seen as a way to increase responsibility by borrowers (operator-payee principle) and instill in the community a distinctive image of the organization, and should never be perceived as an encouragement to delinquency.

Therefore, DID believes that no rescheduling or grace period should be allowed, for repayment of loans. Outstanding loans cannot, in any way, be renegotiated. During the analysis, the capacity for repayment was assessed.

Borrowers are therefore able to meet their obligation to repay their loan. In exceptional instances of *force majeure* (environmental) and/or circumstances beyond a borrower's control, the rescheduling, extension or renegotiation of an outstanding loan may be authorized without affecting the borrower's possibility of obtaining a new loan. This does not relieve borrowers of the repayment requirement and they remain responsible.

DID bases its interventions on the following elements in order to better forecast and avoid a delinquency crisis.

- Make all efforts to create an image and philosophy that considers late payment to be completely unacceptable. Adopt a zero tolerance policy by paying constant attention to delinquency rates. A policy on loan monitoring must list the steps to be taken when loans become delinquent.

- Institute a process of ongoing improvement. Efforts must be made to maintain best practices in order to limit the risk of deterioration. Most delinquency situations are caused by lax practices. During institutional development, methodology tends to be interpreted differently by operators.

- Develop a system that provides staff with fast and reliable data on delinquency situations. The more quickly that loan officers obtain information, the more quickly they can react and devote time to borrowers (effectiveness and close proximity to customers).

- Adapt loan products to the needs of clients. Clients must consider access to credit as an asset for their own activities. The issuing process must be simple, effective and fast. Motivation mechanisms (ex: incentive remuneration) will not operate if the clients do not appreciate the service provided.

- Respect the principle of close proximity. Maintain contact with borrowers. The targeted clientele must feel the presence of the lender. Lenders via their representatives must demonstrate that they attach great importance to the activity. This relationship will strengthen the implicit contract by stimulating the relationship of confidence and ensure the presence of the lender for future borrower needs. Nothing works better than a visit to the place of business in order to properly understand how it operates.

- Establish an acceptable target level for delinquency, taking into consideration the costs and impact of delinquency on the institution. Establish a prudential reserve under a policy of making adequate reserves for loans and a write-off policy for bad loans that is applied in a systematic manner.

Importance of incentive mechanisms

The advantages and interest in reimbursing a loan must be higher than the advantages and interest in not reimbursing it. This principle must be applied to everyone involved (borrowers and employees). In the aim of making this concept tangible, motivation mechanisms tied to incentive remuneration should be part of a policy linked to the credit policy. For borrowers, these mechanisms may be access to a higher loan level at renewal or even an interest rebate offered to borrowers with spotless records. Taking a different approach, a system to dissuade delinquency could include penalties, lack of eligibility for future loans, collection of collateral, or legal measures. For employees of the institution, this system would be based on the quality of the portfolio and would have the effect of transferring part of the responsibility to the loan officers. Moreover, loan officers properly supported by their institution are better able to evaluate and avoid the causes of delinquency. In many cases, incentive pay has proven very effective and allowed for better monitoring of loans and closer contact with clients while simplifying staff control measures.

The following reference documents provide support for the portfolio monitoring strategy policy that DID proposes to its partners:

- Calcul, analyse et gestion du portefeuille à risque (French only), available in the DID list of tools
- Conception et mise en place d'une stratégie de rémunération incitative (French only), DID tool 4
- Rapports de gestion SIGDID portant sur le portefeuille (French only), available on request from the DID.

Recourse to a guarantee fund

DID considers that risk-sharing by relying on access to guarantee funds makes it possible to serve certain target clienteles and encourages their use subject to certain conditions.

Guarantee funds are intended to foster access to credit for certain categories of borrowers that have specific risks linked to the quality and value of the guarantees offered as collateral for the financing request. For example, this may be the case in the agricultural sector which is often subject to major fluctuations. In fact certain promoters, who find access to traditional financing difficult due to a lack of personal guarantees or insufficient initial outlays, may still obtain a loan from a financial institution, thanks to intervention by organizations offering to share part of the risk linked to the loan.

Access to such funds will have a major impact on reaching target clienteles, while guaranteeing an acceptable level of risk from the point of view of the lender. However, the guarantee fund only provides partial relief for a lack of guarantees on the part of borrowers. In no instance should it serve to cover a lack of other criteria that are fundamental to the analysis of the loan request. A lack of capacity for repayment or a serious doubt about borrower ethics must not be compensated by the partial coverage offered by a guarantee fund.

DID recommends that the guarantee funds introduced (by the institution itself internally or by an external agency) cover only part of a loss in order to make the institution responsible for its management of credit risk. Making the institution responsible avoids a drift towards lax lending practices and will contribute to maintaining and developing the analytical abilities of individuals dedicated to authorizing loans.

Whether it involves a reserve set up by an institution based on contributions by borrowers (in the form of contingency funds or guarantee funds) or by a group of affiliated institutions, private funds or state guarantees that provide support for development policies, these funds represent a risk management tool and are part of an overall approach to management of a loan portfolio. They must be utilized when available or their creation must be envisaged when required to maintain the assets of the institution.

Aware of the need for access to these funds by the institutions, DID set up, through the intermediary of its investment division, a guarantee fund that is at the disposal of its partner institutions. This expansion of its technical support function highlights its level of commitment to development of the social economy. This contribution is proof of its conviction that there is a chance for community finance institutions in countries in development or transition to achieve tangible success.

CONCLUSION

DID intends to make financial resources accessible to people in a sustainable manner by working with its partners. In order to be able to render this service to its clients in a permanent and effective way, the institution must rely on principles that encourage risk management of its activities and which will allow it to reach a sufficiently large number of borrowers.

Since the loan portfolio represents the main productive asset of a community financial institution, management of credit risk has proven to be a key factor in performance. Credit risk and the risk of financial loss result from the inability of borrowers to completely fulfill their financial obligations to the institution for whatever reason. Therefore it is necessary to implement a credit policy that through its application will provide security for the assets of the institution:

- Institutions must diversify their activities in order to create a critical mass so that the clientele can profitably support supervisory organizations. To become profitable, they must offer services not only to the poorest but also to other categories of the population who do not have access to financial services. At the same time, community finance institutions must not themselves create excluded clienteles. They must deliver services to the poorest.

- In order to withstand the test of time and continue to offer financial services to this clientele, activities must be based on and managed according to profitability. Product tarification must provide profitable operations and cover the risks incurred.

- The effectiveness of credit activities is an essential condition for profitability. The costs of reaching profitability must be minimized. Key elements are productivity and volume. Simplicity and rapidity must characterize management and decision making.

- The basis for reimbursement remains the ability to generate surplus revenue based on an activity. To minimize the risks of loans made, one must rely on experience and knowledge of the borrowers in addition to the realistic nature of the activity and its ability to generate surplus income. At the same time, repayment terms and conditions must be harmonized with the nature of the activities financed. That is why it is important to understand the environment and the operations of the business and the sector of activity in which it is involved.

- Credit remains a commercial activity. It is relatively easy to solicit borrowers while it may prove extremely difficult to recover the amounts paid out in loans. Credit management must be inspired by strict and rigorous management criteria aimed at preventing out of control situations.