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www.*MicroSave*.org
info@*MicroSave*.org

Toolkit for

Individual Lending for Credit Officers

Prepared by ShoreBank Advisory Services (Paula Tjossem and Tina Ohmann) and Lynn Pikholz and David Cracknell

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ShoreCap Exchange
ShoreCap Exchange Corporation
2230 South Michigan Avenue, Suite 200
Chicago, Illinois, 60616 USA

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The authors of this toolkit welcome comments, feedback, training tips, new examples and fresh ideas from you, the users of this manual. Your thoughts and comments are anticipated and welcomed for the next version.

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Session 1: Introduction

Q: What is individual lending?

In microfinance, Individual Lending is defined as a loan to one individual. Individual Lending is the step above group lending. There are five main determinates that differentiate individual lending from group lending, including:

- Lending to a single person
- Larger loans
- More security/collateral required
- More thorough analysis process using cashflow
- Monitoring of the business after loan disbursal

1. Bank Rakyat Indonesia attributes its successful micro lending to 5 factors:
2. Bank Rakyat Indonesia's success in bringing up its outstanding micro loans to its present levels is mainly attributable to:
3. Extensive market reach and presence in areas with perceived strong loan demand
4. Using adequate knowledge of market needs and peculiarities to design appropriate loan products
5. Standardized and simplified procedures, which enable it to process loan requests quickly
6. Decentralized operations of unit offices
7. Deliberately limiting service coverage to each unit office, to capitalize on knowledge of local markets, ensure good borrower selection and simplify their individual risk monitoring.

Q: Who needs to learn about individual lending?

Regardless of the country in which we work or the organization in which we operate, there are many individual lending professionals who need to learn about individual lending. Some of our titles are:

Teller
Accountant
Credit Administrator
Appraisal Officer
Credit Officer
Credit Analyst
Business Loan Developer
Branch Manager
Head of Retail Credit
Head of Credit
Head of Commercial Lending
Internal Auditor
MIS officer
Chief Financial Officer
Chief Operations Officer
Director
Board Member

Successful lending is a team effort and therefore everyone who touches it, from the teller to the Director and even the Board of Directors, needs to understand it. Our common ground of course is our dedication to the small business market. From a purely economic perspective, we are the ones who are responsible for the allocation of a scarce resource (money). We allocate this resource by making a credit decision: approve or decline a loan request. We should approve loan requests for purposes that will return not only the principal and interest, but will also give the borrower an adequate return, above and beyond the cost of capital. That is the economic rationale for what we do.

Q: What are we doing by giving individual loans?

We seek to ensure that credit is accessible to small and micro businesses that have been historically "unbanked", by evaluating repayment ability using a cashflow as the predominant way of determining "credit worthiness."

Small businesses provide jobs. Hence, we play a role in expanding the job market.
We provide a return for the institutions in which we work or have an ownership interest.

In effect, we make deals happen. We provide money for small businesses in an effort to expand them and with the expectation that they will pay us back. In each and every case, there is some element of risk in assuming they will in fact pay us back. Lending is a risky business.

When describing businesses throughout this manual, the words "micro" and "small" are used interchangeably. These terms have different meanings, depending on the lending environment. Some banks might consider a particular business micro, while an MFI would consider the same business small.

Q: What is included in the course?

The purpose of this training is to enhance the current level of the participant's loan processing and credit decision-making skills. It will explore areas of improvement with respect to bringing greater efficiencies to the entire process, both individually and collectively.

The course consists of two major parts: Credit Officer's Individual Lending Toolkit and Manager's Individual Lending Toolkit.

The Credit Officer's Individual Lending Toolkit is made up of ten sessions, which will be taught over the course of four to five days. Participants enrolled in the training course should expect to gain, by the end of the next five days, a good understanding of:

Introduction

1. **Step-by-Step: the loan process**: This session goes through the detailed steps the Credit Officer must perform to complete the loan analysis, get the loan approved and collect and monitor the loan.
2. **Marketing and Customer Service:** This session explains in detail how Credit Officers can improve their marketing techniques and customer service through plans and proven methods of working with individual loan clients.
3. **Credit Analysis:** Explains the process whereby the Credit Officer evaluates the client using the screening, application and loan appraisal tools.
4. **Cashflow Analysis:** Teaches the Credit Officer how to use the cashflow tool to determine the client's repayment capacity. It is the most important part of analysing a client's business.
5. **Financial Statement Analysis:** Briefly reviews the income statement and why it is not used in this methodology. This session also reviews the balance sheet and how to effectively use it to analyse a client's present asset, liability and equity situation.
6. **Collateral**: Reviews the security requirements for the individual loan and details examples of various types of collateral, combinations and specific real examples.
7. **Loan Structuring**: Instructs the participants, after evaluating the repayment capacity, on how to properly evaluate the project needs and formulate a proper loan amount, repayment format, and disbursement conditions.

8. **Loan Approval and Documentation:** Takes the Credit Officer through a series of practical steps, which will be necessary for obtaining approval of the loan and disbursing the loan.
9. **Collection and Monitoring and Problem Asset Management** from a Loan Officer's perspective: Reviews the necessary, but often forgotten, procedures the Credit Officer must follow after a loan is disbursed to maintain a healthy loan portfolio and collect on bad loans.

The Manager's Individual Lending Toolkit is made up of five sessions, which will be taught over the course of two to three days. Some of the key sessions include:

Portfolio Management: Instructs a Manager regarding the key ingredients for successful lending programs, including: principles for management, managing scale, quality and productivity, reports necessary for managing a portfolio and how to use these, overall risk management and the role of the board.
Collections and Monitoring: Builds upon the Credit Officer toolkit, but instructs from the Manager's point of view. It informs the management about collection issues, alternative ways to monitor, how to identify when a loan is going bad and what to do about it.
Problem Loans: Builds upon the Credit Officer toolkit by delving deeper into the costs of write-offs, causes of delinquencies and problem loans and ways to address problem loans and workout from the Manager's perspective.

Q: What kind of tools do we use to help us?

Throughout this seminar, we will be introducing many tools to help you become proficient at individual lending, such as:

Checklists: Used as a support to help us remember the specific steps in the sub-processes to lending. This is a productivity tool and a risk management tool. For instance, think about the books of checklists that commercial pilots must complete prior to each and every flight.

Standardized Forms and Procedures: Implemented from the first instance we capture our client's information, to the presentation of the loan request to the Credit Committee, the forms and procedures should be standardized and contribute to a streamlined flow of data.

Cashflow Analysis: An analysis process, which evaluates the inflows and outflows of cash in a business and household. It determines the amount of the loan and repayments a client can afford. Although this is the most important tool used in individual lending, there are many other determinants in individual lending, such as project purpose, management, customers, suppliers, references and collateral.

Red Flags: Warnings that there may be a risk with the borrower that would preclude an approval or at that least requires additional scrutiny. It is a tool for detecting these risks early, so that the process can be stopped and time is not wasted. Not all red flags will preclude an approval, but they do identify areas that must be addressed immediately and conveyed to management and the Credit Committee.

Manager Reports: Used for tracking loans through sub-processes, from receiving a completed application, to making the final disbursement and following loans throughout their repayment.

Q: What exactly is the cashflow?

The cashflow is a tool that shows the cash coming into and flowing out of a business. It is different from the profit and loss statement, which shows all sales and expenses, not only cash sales and cash expenses. For example, a profit and loss statement for a furniture store shows sales for wooden desks, including sales that were made on credit. The cashflow, however, would only shows sales for which customers have already paid.

Simple Cashflow Formula:

+ Total Business Income
- Total Business Expenses
= Net Business Income (Business Income - Expenses)
+ Total Household Income
- Total Household Expenses
= Net Household Income (HH Income - Expenses)
= TOTAL NET INCOME *(Net Business Income + Net HH Income)*

Step 1: The cashflow starts with *Total Business Income* and subtracts *Total Business Expenses* to get *Net Business Income* (in cash).

Step 2: *Household Cash Expenses* are subtracted from *Household Cash Income*, to determine *Net Household Income* (in cash).

Step 3: *Net Business Income* is added to *Net Household Income* to find *Total Net Income*.

All of the detailed income and expenses must be organised into the daily, weekly or monthly columns. This is according to how the income and expenses are received and paid. Rent for example, is usually paid monthly and therefore would be listed in the monthly column. Cashflows will be covered later in Session 5.

Q: Why is the cashflow the most important tool in individual lending?

What repays the loan? CASH. Thus, we need to know when and how often cash comes in and flows out, in order to determine the repayment capacity of the client.

Q: If you attend the workshop, what happens after?

After the workshop, *MicroSave* or ShoreCap Exchange representatives will coordinate with your MFIs and visit your institution. This will help your MFI get started on evaluating your current individual lending product or setting up new systems. Also, this follow-up will ensure that the individual lending training, which you have received here in the classroom, is actually instituted and used in your MFI.

Session 2: Step-by-Step: The Loan Process

Q: Why is the lending process important and why should it be very structured?

A highly structured lending process ensures:

- Efficiency – process more applications, disburse more loans (shortest possible time period from application to disbursement), satisfy more clients, and make more profits.
- Clear and easily understood processes and forms - improving the work flow for all participants, MFI staff and clients, in the loan process.
- Reduced risk - participants in the process are less likely to omit any details, eventually lowering the overall risk.

In summary, structure makes the process more efficient and easily understood, and reduces the risk.

Q: What is the role of the Credit Officer?

A Credit Officer must wear many different hats. At most institutions, Credit Officers must be everything and do everything. They must take a client through the lending process, from the first introduction to the MFI and products to full repayment of the loan. In some institutions, they underwrite several different types of loans, as well as sell many different types of bank products.

A MFI in South Asia describes their Credit Officer Responsibilities as including:

- Marketing loans and deposit products
- Discussing loan requirements with borrowers
- Evaluating the credit request and preparing the appropriate recommendations
- Monitoring repayments
- Collecting overdue instalments

The Credit Officer is expected to be in the field 80% of the time and cover as many potential borrowers as possible. Each Credit Officer will normally have about 250 – 300 accounts in his/her portfolio. Credit Officers generally have several years of experience as tellers or deskmen within the MFI before becoming Credit Officers.
(ShoreCap Exchange, SME Training, Manila, 2005.)

Q: Why is efficiency in using applicants' time important?

For borrowers, coming to the bank, discussing with the Credit Officer, filling in forms, and other processes takes a lot of time. Time is money for both customers and the MFI. Some of these costs are transaction costs, which include the transport cost of visiting the Credit Officer at his/her office. Some are opportunity costs, which relate to income lost while the applicant is visiting the Credit Officer, rather than running his/her own business. Showing the customer that the institution values his/her time, by using as little of it as possible, helps to establish a good working relationship. If a Credit Officer takes this approach, the customer will have a favourable impression of the institution. If a client is satisfied, s/he will not take his/her business to another bank or MFI. Importantly, if there is a long delay between application and Credit Committee, client information will be outdated and will need to be updated, wasting time and frustrating the customer.

Financing relationships are built on trust between the customer and the MFI. Trust takes time to establish, and is achieved through creating a polite but friendly and comfortable working relationship

with customers. The customers of an MFI should be seen and treated as its largest asset.
At the same time, every loan involves some level of risk. It is of paramount importance to go through each step of the loan process thoroughly and professionally, to make sure that the product is implemented properly and to ensure that the MFI is safeguarded against any further risk. With each subsequent step of the loan process continuum, the level of risk increases. As time progresses, the Loan Officer has spent considerable time on the loan application and wants to close the deal as soon as possible.

The risks associated with the development of the loan product from an institutional perspective are different from the risks associated with the Credit Officer's analysis and due diligence. These risks will be explained further throughout this session.

The drive to be efficient needs to be balanced by necessary risk mitigation strategies. Every loan involves some level of risk. The role of the Credit Officer is to identify, assess and measure this risk. Risks taken during the loan process should be thoroughly assessed and managed.

Q: What are the goals of having an established Step-by-Step Lending Process?

The goals of the Step-by-Step Process are to eliminate borrowers that don't qualify early on, to manage risk and to balance it with efficiency, at each stage of the lending process. The process helps to reduce time for both the applicant and the institution before disbursement. It also ensures that a standard set of procedures and policies are respected, in order to implement a product consistently. These measures will reduce credit risk by improving the institution's overall productivity and customer satisfaction.

Steps of the Lending Process
Step 1: NEW CUSTOMER INTRODUCTION
1.1 First client contact – screening with Loan Administrator
1.2 Information session (optional)
1.3 Completion of Application Form by client
1.4 Credit Officer obtains more information about the business and client for the application, reviews it with supervisor and decides whether to move forward or not
1.5 Credit Officer starts file for client and fills in appropriate items on the Checklist
Step 2: LOAN APPRAISAL
2.1 Credit Officer conducts site visit to business and reviews collateral options
2.2 External checks and references
2.3 Credit Officer completes Loan Appraisal form and Cashflow form
2.4 Surprise visit to the company (for loans over $3,000 only)
2.5 Final analysis and loan structuring
2.6 Final review by Credit Manager
Step 3: APPROVAL
3.1 Submission to Credit Committee
Step 4: DISBURSEMENT
4.1 Loan documentation

4.2 Appropriate authority reviews all documentation and signs disbursement request; loan disbursed
Step 5: MONITORING
5.1 Monitoring and follow up of the client after disbursal

Although the exact steps in the lending process vary from organization to organization and from product to product, it is important for a MFI to have a clear set of steps for taking the customer through the first contact, analysis, disbursement, monitoring and repayment. There is no one right way to do these steps. In fact, the steps may be country specific due to varying markets, laws and regulations. If local conditions are well-suited, we would recommend the steps in the order suggested above. This step-by-step guide, once designed, should be incorporated into the institution's operations manual. Each step should be assigned a maximum time period for completion and be planned by the organization for each loan product.

Timing allocated to lending process

Steps	Business Days to Completion
Step 1: NEW CUSTOMER INTRODUCTION	
1.1 First client contact – screening with Loan Administrator	1 day
1.2 Information session (optional)	
1.3 Completion of Application Form	Same day
1.4 Credit Officer obtains more information about business and client for the application, reviews with supervisor and decides whether to move forward or not	Same day
1.5 Credit Officer starts file for client and fills in appropriate items on the Checklist	Same day
Total days	1 day
Step 2: LOAN APPRAISAL	
2.1 Credit Officer conducts site visit to business and reviews collateral options	1 day
2.2 External checks and references	Same day
2.3 Credit Officer completes Loan Appraisal form and Cashflow form.	Same day
2.4 Surprise visit to the company (only for loans over $3,000)	1 day
2.5 Final analysis and loan structuring	1 day
2.6 Final review by Credit Manager	Same day
Total days	3 days
Step 3: APPROVAL	
3.1 Submission to Credit Committee	1 day
Step 4: DISBURSEMENT	
4.1 Loan documentation	1 day
4.2 Appropriate authority reviews all documentation and signs disbursement request; loan disbursed	Same day
Total days	2 days
TOTAL # OF DAYS (*not full working days)	6 days

As loan deals develop at different rates, Credit Officers are taught to continuously prioritize their potential clients. Credit Officers must manage their time in a way that allows faster moving transactions to be underwritten and disbursed more quickly and slower ones to be moved down the priority list. Credit Officers must continuously set priorities within their own pipelines and move all clients through the process in the quickest manner possible. The client's number one priority is to receive the loan.

*The number of days does not necessarily represent full days for completing each task. Also, many Credit Officers get caught up in time delays at various points in the lending process.

Typical reasons for delays include:

- Long delays in receiving Credit Committee approval from the head office; some Credit Officers will give the maximum locally authorized amount for this reason.
- The client takes a long time to submit all necessary documents.
- Lengthy legal and collateral registration processes in some countries.
- Delays in receiving information from clients to fulfill conditions of disbursement.
- Client delays in finishing part of a project so that the MFI can disburse the next part of the loan.

Q: What happens during Step 1: New Customer Introduction?

Step 1
NEW CUSTOMER INTRODUCTION
1.1 First client contact – screening
1.2 Information session (optional)
1.3 Completion of Application Form
1.4 Credit Officer obtains more information by phone, if necessary, about business and client, reviews with supervisor and decides to move forward or not
1.5 If the information is favourable, the Credit Officer starts a file for client and fills in appropriate items on the Checklist

The goals of the Loan Administrator and/or Credit Officer during Step 1.1: Client Screening are:

- to screen out, in the first meeting, applicants who are not eligible for borrowing under the institution's eligibility criteria
- to sell the program to applicants who are eligible
- to help applicants understand the institution's products and if they are in line with their expectations
- to start going through the client screening form if the client is eligible

The applicant first meets with the Loan Administrator or Credit Officer, depending on the function in the organization. The goal at the first meeting with the applicant is to screen out applicants who are not eligible for borrowing under the institution's eligibility criteria and to sell the program to applicants who are eligible.

This first contact is important because this is where applicants get a chance to understand the institution's products and determine right away if they are in line with their expectations. It is important for the Loan Administrator or Credit Officer to be well trained, understand the products and not waste time on ineligible clients.

The Loan Administrator or Credit Officer gives the applicant information about the MFI and its products, and begins going through the client screening form. Only if the borrower meets the eligibility criteria, will the client be directed to the next step for further review and given a copy of the application form.

Q: What is the Client Screening form?

The Client Screening form is a one-page tool that helps the Loan Administrator or Credit Officer complete the initial interview as quickly and efficiently as possible. The form should include basic questions on the most important information about the customer and whether the applicant complies with all eligibility criteria set by the institution.

The first step is to obtain key information about the customer's request:

- Personal information about the borrower.
- Information about the business.
- What is the loan amount requested?
- What is the purpose of the loan? (business start-up, expansion, working capital, equipment purchase, etc.)
- Do the client's needs fit the loan product?
- Are they eligible for the loan according to the MFI's eligibility criteria?

Using a screening form is highly recommended because it screens out the unsuitable clients and businesses and does not waste the MFI's or the client's time. MFIs should reject clients sooner rather than later. Dragging the client along and then later disqualifying him/her creates a bad image for the institution. The screening process eliminates borrowers who do not qualify and enables the Credit Officer to move ahead with businesses that are eligible.

If the client fits all the eligibility criteria, s/he moves to the next step. Later, the Credit Officer can use information given during the screening to cross-check information the applicant gives later.

If the client does not fit the eligibility criteria, the Administration/Credit Officer can reject the client, marking the ineligible item clearly on the Screening Form. This should be done with care and respect for the client.

Q: What is the Information Session?

The purpose of an Information Session is to inform a larger group of potential borrowers about the individual lending program, the loan products and the loan process. Information sessions are also a form of marketing and advertising. First, the product is promoted in a particular area. The information session is usually held within a few days or a week following the promotion. Ideally, about 25-30 potential clients attend the session at a location convenient to them, such as a public hall or school. The session is most often led by the Credit Officer, but it can also be led by a Loan Administrator or another well-informed staff member. If the leader does not know the answer to a question asked during the session, they should write the question down, take down the person's contact information and get back to them later with the answer. The information session covers a range of topics, as listed below and is followed by a question and answer session. A flip chart and/or projector may be used to illustrate certain points and provide examples for the Information Session.

- Introduction
- Credit needs
- Loan products & services
- Individual lending methodology, collateral
- Loan parameters (size, term, rate & fees)
- Loan application process
- Loan default and consequences
- Required documentation and next steps

At the beginning of every information session, the Credit Officer asks the attendees to sign-in, providing their name, address and telephone number. A sign-in sheet is useful in compiling potential clients for follow up.

Instead of having a formal information session, one MFI in Southeast Asia strategically placed televisions playing a video describing different products near the entrance of its branches. They would play the information session (i.e. advertisement) over and over all day long to give introductory information to the clients. This was less intimidating than having to sign up for an Information Session and more convenient, as the client could come at any time to view the video. If after watching the video, the potential client wanted to meet with a Credit Officer, they could. If not, they were not obligated to. Meeting the Credit Officer is sometimes intimidating for new customers.

NOTE: This step may not be used by some institutions. Some institutions go directly from the screening to the application step. Other institutions may include this step, but have it before the screening. While the information session may be an efficient way to communicate the product eligibility criteria and features, in some cases, it may be unnecessary if the product is already well known. Also, it may be viewed by some institutions as an additional cost, both internally and for borrowers.

Q: What is the final step in new customer introduction?

After the Screening and Information Session (if the MFI has this step) the client is given an application form. The client should complete this simple one page form on their own. They can ask the Credit Officer for clarification, but the Credit Officer should not fill it in for the client. The Credit Officer should encourage the client to complete the form immediately in the office. This way the client can ask questions as they go along and s/he can return it to the Credit Officer immediately to speed up the lending process. When the application has been completed and returned, the Credit Officer reviews it and asks additional questions, if needed.

If the client and the business look promising and there are no glaring problems, the Credit Officer should set up a scheduled site visit for that the same day or the next. At this point, some MFIs also have the Credit Officer inform the Manager about the client and together they make the decision to continue or reject the loan.

Q: What is the next step in the lending process?

The next step is the credit analysis. This step is relevant only if a decision was made to proceed with the client.

Step 2
CREDIT ANALYSIS
2.1 Credit Officer conducts site visit
2.2 External checks and references
2.3 Credit Officer completes Loan Analysis form and Cashflow form
2.4 Surprise visit to the company
2.5 Final analysis and loan structuring.
2.6 Final review by Credit Manager.

Q: What are sources of information for Credit Analysis?

A few sources Credit Officers will use to perform their credit analysis are:

- Customer
- Documentation

- Site visit
- External checking

The Credit Officer must check, check, and then check again, in each area!!!!

This section will be covered in more detail later.

Q: What is the purpose of the site visit?

The site visit is one of the most crucial steps in the pre-approval process because direct observation and one-on-one conversations with each potential borrower provide precious information for the Credit Officer in his/her assessment of the applicant's credit worthiness. A site visit allows the Credit Officer to inspect the business premises and confirm what the borrower stated and wrote about the company's premises, production or sales space, assets, and inventory amounts and turnover. It allows the Credit Officer to meet and interview the Managers and employees. Lastly, the Credit Officer can gather financial data to evaluate the potential of the business. The objective of the site visit is to make an objective judgment about whether the business is well run and has potential.

Next, the Credit Officer should focus his/her visit on reviewing the entrepreneur's management capacity, market potential and importance of further financing through borrowing to further his/her business goals. If the Credit Officer manages to remain objective, curious and thorough during the site visit, then it is a very powerful tool to evaluate the information gathered in the paperwork.

Credit is both an art and a science. Part of the site visit involves artistic thinking, using intuition (gut feeling) to determine if people are being honest about the information provided, talking to partners, family members of staff, and being flexible when site visits do not always take place as expected. Site visits can be used to double-check written information, but also to collect information on the applicant's skills and personality and whether or not s/he is a good Manager/owner.

In this role, the Credit Officer wears a "detective hat" while conducting the site visit. S/he needs to look for details that might inadvertently be hidden. The Credit Officer should have a very thorough look around the premises. Look for untold clues as to the behaviour of management. For example, the Credit Officer should view the conditions of the bathrooms, lunch room, outdoor areas, behind the building, inventory and storage conditions, behind the counter, under the cans on the shelf, in the freezer, back up for electricity and expiration dates of perishable items.

Q: What is the Loan Appraisal Tool?

The Loan Appraisal Tool is a thorough review of the applicant's situation and business and is a critical component in the decision making process. This form describes the proposed loan, motivation to repay, risks and if the proposed loan project makes good business sense. It is the responsibility of the Credit Officer to complete this form, not the client. How to complete this form will be taught step-by-step in Session 4 Credit Analysis.

The details of the form depend on the size of the program, the competition, the environment, and size of the loans. The Loan Officer needs to thoroughly understand and be able to use the form as a tool before s/he goes on the site visit.

The Loan Appraisal Form includes the following:

- General baseline information (borrower, business)
- Loan impact on business
- Business information (business history, credit history, Manager qualification, suppliers, customers, competition)
- Collateral

- References
- Balance sheet
- Cashflow information (actual form is separate)
- Credit Officer recommendation
- Credit Committee review and decision

The Loan Appraisal Form is a critical component in the decision making process and helps to answer three crucial questions:

1. Is there a GOOD FIT between the customer and the company?
2. Will the customer BE ABLE to repay?
3. What are the key RISKS?

At Association of Cambodian Local Economic Development Agencies the borrower completes the loan appraisal or business plan, which is then submitted to the Credit Officer for review and analysis.

Some MFIs think by having the client fill in the loan appraisal form, it is more time efficient and the client will reveal more information. In ShoreBank's experience, the client is intimidated by having to fill in the loan appraisal form, becomes frustrated from not knowing how to do it, and rarely completes it correctly. The Credit Officer therefore spends a lot of time correcting the information, resulting in lost time for both the client and Credit Officer. The Credit Officer also builds a relationship by 'helping' the client complete the form and is able to verify most of the information on the spot. Ultimately, ShoreBank has found that it is actually more efficient and helpful having the Credit Officer, not the client, complete the form.

Q: What is the Cashflow Analysis?

The cashflow analysis is one of the most crucial aspects of the individual lending methodology and it helps to ascertain whether the borrower will be able to repay. For this step the Credit Officer prepares a one page cashflow form, which is an expanded version of the simple cashflow presented earlier.

An entire session is dedicated to this subject later in the course, in Session 5 Cashflow Analysis.

Q: What is an external check and why is it important?

A good Credit Officer NEVER takes for granted what the customer says. Good lending practices depend on fact-checking and character-checking of the borrower from external sources. If the customer has borrowed before, it is essential to check whether the loan was repaid as agreed.

The Credit Officer should speak with at least three references, who know and do business with the applicant (not related to the client). For example, the Credit Officer could speak with the following references:

1. At least one supplier - to make sure that the applicant is reliable and pays his/her bills on time.
2. At least one creditor - to see for how long items are given on credit and verify outstanding amount owed.
3. At least one employee - to get that person's description of the business activities and if they are paid on-time.
4. At least one competitor - to see if they are a stiff competitor or if something is wrong.
5. Landlord (for residence and business) – to determine if they are responsible tenants.
6. Neighbours - to verify how long they have been in the community and reputation.
7. Community and church leaders - to verify character.
8. Money lenders - to see if there are or have been any outstanding loans.
9. Banks - to verify accounts, payments, loans, etc.

10. Market official (if the client is a trader or owner of the market).
11. Others related to the business.

Note: When dealing with larger loans (approximately US$3,000 and above, depending on your environment), the external checks on the client's character may be overtaken by more formalized "capacity" lending. This means that the financial indicators will be more important than, or just as important as, the character of the borrower. Therefore, in addition to looking at the historical cashflows for larger loans, more attention will be paid to the type of collateral and other financial indicators, such as competition and inventory levels/turnover. This will be discussed later in this session.

Q: What is a surprise visit and why is it important?

A surprise visit is much more likely to represent a typical day in the business. An applicant who really wants a loan will make sure everything looks beautiful when you come for the scheduled site visit. Be sure to compare both visits! At the same time, in order to make the lending process faster, many MFIs do not include this step in their lending process.

What should a Credit Officer look for on the surprise site visit? The Credit Officer checks the information collected thus far regarding management, work premises, inventory, equipment, books, customers, employees present and other important factors and compares it to the situation on the surprise site visit. Is it the same or have things changed since the scheduled site visit?

The Credit Officer should be reminded to compare both visits (the scheduled and the surprise), when doing the final review. S/he should bring his/her notes from the previous visit.

Be Careful and Thorough!
During a surprise site visit to a business in Bosnia, the owner was not found at the shop and the television and stereo inventory was significantly lower than before. What happened? The cashier did not know the client. She said that someone else owned the shop. For the scheduled site visit, the potential client 'borrowed' his friend's shop and added extra inventory to make it look good. He did not have a business at all and set up the entire scam just to get a loan.

Note: Institutions may want to include the surprise site visit for larger loans only, suggested above US$3,000. This will allow for the Credit Officers to be more efficient while analysing the micro loans.

Q: What is the final analysis and loan structuring?

The Credit Officer reviews the Screening, Application, Loan Appraisal and Cashflow forms. Then s/he completes his/her analysis and makes his/her recommendation, making sure the final documentation is in order and checklist is completed. This step is important because the Credit Officer must be confident in recommending the potential client and business to the Manager and Credit Committee.

Session 8 will specifically address loan structuring.

Q: What is the final review by the Credit Manager?

The final review by the Credit Manager can also be referred to as: "Two Pairs of Eyes"

As a general rule, it is important that every loan be looked at by someone who has not been involved in the loan process thus far. When dealing with new customers on larger loans, a second person should not only review the loan, but visit the customer before loan approval.

Loan Officers must remember of course, that they will be held responsible for their loans and overall portfolio. This step will make the Loan Officer feel stronger about the loan if the Credit Manager is satisfied with it.

Q: What happens during the approval phase?

Step 3: APPROVAL
3.1 Submission to Credit Committee

Once the loan is structured and due diligence is completed, the deal should be presented to the Credit Committee. During the Credit Committee phase, each Credit Officer will recommend prospective clients and applicable paperwork to the members and answer questions the committee may have. The Credit Committee discusses the merits of the proposed project, and votes to approve, approve with additional conditions, postpone, or reject.

The composition of the Credit Committee varies by institution, portfolio and level of decentralisation. Some institutions will have a Credit Committee of a few members, who meet regularly to consider loans. Other MFIs may delegate loan authority to Senior Credit Officers, Branch Managers and/or Regional Managers. Approval will be decentralized at the agency or branch level at some MFIs, whilst others will have all approvals made at the head office. These are variances that the MFI must assess while trying to balance the most efficient process with the least risk potential. In any case, to protect the objectivity of the institution, every loan should be approved by more than one person.

Example of Loan Approval Authority Levels:
Bank Rakyat Indonesia loan approvals are decentralized, contributing to a faster overall processing of credit requests at the unit office level. Credit approval authorities are as follows:

Unit Manager	up to $ 750 (Rp. 7,500,000)
Sub-area Manager	up to $ 1,500 (Rp. 15,000,000)
Area Manager	up to $ 2,500 (Rp. 25,000,000)
Branch Manager	up to $ 5,000 (Rp. 50,000,000)

All requests for micro loans can be decided locally and need not be referred to the regional or head office. Recommendations are made by the Credit Officer and endorsements of the next higher authority are required in all proposed credits. Bank Rakyat Indonesia's confidence in decentralizing credit approval authorities is largely attributable to its standardized procedures, smaller credit risk exposure per borrower, and the adequate experience it has in microlending.
(ShoreCap Exchange, SME Training, Manila, 2005.)

Loan Rejection: The trainer asks for examples from participants who have had loans rejected by the Credit Committee. This can usually be somewhat of a "venting" session and gains understanding among the participants that it is something that they will all have to do and that it is not an easy part of their job. Generally, most deals should be accepted if they make it all the way through to Credit Committee. If a high percentage of deals are rejected at the Credit Committee level, there is a need to look at the process up to this point. Otherwise, the client, Credit Officer and Credit Committee have wasted a lot of time. These possibly could have been weeded out at an earlier stage, made easier for the client and more efficient for the MFI.

If a customer is rejected, the Credit Officer should be very careful in communicating this to him/her, so as to avoid spreading negative perceptions of the institution in the same community. The Credit Officer should communicate this information to the client in written form for documentation purposes. It should be either delivered promptly, or the client should be phoned and the letter should follow. The documentation can be simple – a short written letter on a standard form with a section explaining the reason. Participants should be reminded to be very diplomatic and let the customer down easy. Remind participants not to drag on and make further promises.

If a customer has been approved, the forms are approved and signed, including loan conditions. The client is informed by phone of the decision and an appointment is made to sign the loan documentation. If a deal is approved with additional conditions of disbursement, the client is informed of these conditions. Then the Credit Officer aids the client in fulfilling the conditions by taking them through the process step-by-step.

The details of the Credit Committee will be discussed later in Session 8.

Q: How is Disbursement handled?

Step 4: DISBURSEMENT
4.1 Loan documentation
4.2 Appropriate authority reviews all documentation and signs disbursement request. Loan disbursed.

Each step leading up to this point is critical to an efficient overall approach, and the Credit Officer must continue to be diligent throughout the entire process.

Even though the loan has been approved, there may still be some outstanding issues that need to be cleaned up, such as additional documentation, for example. If so, the Credit Officer requests any additional loan documentation required for closing, and the loan agreements are then prepared.

If required, the Credit Officer arranges for collateral registration and insurance documentation. Sometimes the MFI uses another individual with connections in the registrar or a lawyer who know the process. The lawyer prepares the loan and collateral agreements. The Credit Officer completes the closing checklist. The Manager or another assigned staff member checks all documentation and conditions and completes a form confirming that everything is in order and requesting disbursement. The documentation is signed by both the client, Manager and, where appropriate, the guarantors. A copy of all documentation and the repayment schedule are provided to the client.

The Credit Officer ensures that all disbursement conditions have been met. The Credit Officer instructs the client on the process of monitoring. Finally, the funds are disbursed to the client through his/her account or directly to the supplier if conditioned by the loan.

Q: What happens next?

Step 5: MONITORING
5.1 Monitoring and follow up of the client after disbursal

During the disbursement process, the Manager and the Credit Officer decide on the monitoring schedule for the client. This schedule depends on the credit history of the client and the high risk periods of the project. For example, MFIs may have a rule that all clients are monitored within one week after disbursal to make sure the loan funds were used for the correct purpose. Clients are monitored quarterly thereafter, to make sure everything is going well. If there is a case with a client where a major sales contract is to be renewed between quarterly visits, the Credit Officer should also schedule a visit at this time, due to the high risk of the contract not being renewed.

According to ShoreBank, accurate appraisals, using cashflow analysis, and regular monitoring of clients have proven to be the most effective methods of maintaining a healthy portfolio.

ShoreBank provided advice to one MFI in the Caucasus. The MFI had one loan product, an individual lending product for loans of $1,000 to $10,000, with a 28% portfolio at risk over 30 days. After one year, the portfolio at risk dropped to 2.5% by instituting cashflow analysis and stricter monitoring policies, as well as establishing a collection officer and stricter collection policies. The MFI maintains 2.5% portfolio at risk to this date.

Red Flags:

1. Make sure that all steps are systematized and time efficient.
2. Be prepared for the reference check visits and the surprise visits. The credit analysis session will review how to ask questions and what to look for.

Session 3: Marketing and Customer Service

Q: What do you think marketing and customer service is?

Before an MFI can start operating, it must have some clients to lend to! Excellent institutions are continually driven by the needs of their target clients and design their loan products to suit those target clients. If an institution is not ready to conduct such tailoring, it should just say NO quickly and get out of this business.

Marketing attempts to understand the needs of the client and to adapt operations in order to meet those needs and achieve greater sustainability (Kotler, 1999).

Marketing addresses:
- new product development
- pricing
- location of operations
- promotion of the institution and its products
- getting the information on the MFI's products to its client base

Marketing for a microfinance institution is **the study of the client.** It is an analytical tool that helps the MFI:
increase the number of clients and/or
determine how to keep clients

Marketing aims to strengthening the institution by maintaining focus on the client. It creates exchanges that satisfy individual and organisational goals. Marketing is a continual process. It doesn't start with market research and end with tracking enquiries; it is a cycle with each element influencing the next.

Q: Why should Credit Officers care about marketing?

Credit Officers are at the heart of a microfinance institution because the portfolio is the largest and most important asset of an MFI - without it, there is no business. Usually Credit Officers are evaluated based on the size and quality of their loan portfolio. Those are the two most important factors for a successful program.

In order to ensure they have large portfolios with only a few problem loans, Credit Officers need to have good client selection. Selection is more efficient if the right sort of clients are coming in for loans in the first place.

Marketing addresses the following issues (DAI, 1999):

1. Who the clients are
2. Who the target clients should be
3. How many clients the MFI should try to capture
4. What clients and potential clients do
5. What potential clients want
6. What products and services will meet clients' needs

UP TO NOW…..

The thinking in the microfinance industry has been shaped mostly by a product driven approach. Companies that just market a product without paying attention to clients' requirements go out of business quickly. "Drop outs" and multiple memberships are usually due to inappropriately designed products. The informal sector (usually unrecognized by MFIs) is the main competition.

Microfinance has been mostly driven by blueprint replication of existing models developed for other markets/clients with the implicit assumption that microfinance clients are essentially homogeneous. This means that a "one product fits all" approach continues to dominate the industry worldwide.

BUT IN REALITY…

The financial needs of poor people are as diverse and complex as those of richer people. For forward-thinking MFIs, these needs represent opportunities that can be met on a profitable basis. There needs to be some recognition of value in retaining customers than attracting new customers who cost more.

Q: Why are existing clients more attractive and important to an MFI than new clients?

It takes time and costs money to attract new clients, whereas existing clients tend to be a captive audience. Additionally, existing clients represent less of a credit risk because the institution knows them. They usually take on larger loans (as their business is on-going), which entails large interest income for the financial institution and usually requires less monitoring and lower administrative costs. **Note** that providing larger loans to existing clients can also lead to an increase in credit risk, due to placing too much confidence in the credit history. Both MFIs and Credit Officers need to strike a balance.

The market-led approach allows banks/MFIs to:
- Identify different client needs
- Tailor products/delivery systems to meet those needs
- Examine cost-effective ways of serving niche markets

Q: How does a Credit Officer have an impact on the reputation of the MFI?

The Credit Officer is the main interface between the MFI and the customer. They are therefore, crucial to creating a professional, friendly and efficient reputation for the MFI. If the Credit Officers do not fulfill their role in building a good reputation, it is important for the MFI to recognize this quickly, as it will affect performance.

Q: What are Credit Officers selling?

In most professional services, salespeople are not really selling expertise. Expertise is assumed and clients are rarely in a position to evaluate it anyway.
Instead, Credit Officers are selling a *relationship*, and in most cases, that is where they need the most work.
If you're selling a service, you're selling a relationship.

Q: What do customers want?

Customers want three things: value, price and service. Value is extremely subjective, but it can still be calculated with some exactness. Value is a balance between:
- Fair price,
- Quality product, and
- Convenient, service-oriented environment.

The right combination of those factors triggers the mutually beneficial exchange between buyer and seller. So, you have to be careful in determining this and making your customers satisfied.

Never get stuck in the middle. Usually, if a firm attempts to achieve an advantage on all fronts, it will achieve no advantage at all. For example, if a firm differentiates itself by supplying very high quality products, it risks undermining that quality if it seeks also to become a cost leader. Even if quality did not suffer, the firm would risk projecting a confusing image. For this reason, Michael Porter argued that to be successful over the long-term, a firm must select only one of these three generic strategies. Otherwise, with more than one single generic strategy, the firm will be "stuck in the middle" and will not achieve a competitive advantage.

Q: What does successful marketing start with?

It all starts with good market research.

Q: What is market research?

Market research is a **process** by which an organization/company can find out:
- *What do clients/potential clients do?*
- *What do they want?*
- *Who are they?*
Market Research is about understanding customers/potential customers.

(Microfinance Center, 2000)

Market Research is about understanding customers and potential customers. It provides information about: (Microfinance Center, 2000.)

- People's livelihoods and needs
- The "financial landscape"
- The services offered are being used and where/why they are not being used
- The risks clients face and how these are being/might be reduced
- How the services offered might be improved

MARKET RESEARCH IS NOT ONLY VERY USEFUL FOR NEW PRODUCT DEVELOPMENT, BUT ALSO FOR PRODUCT REFINEMENT AND PENETRATION OF NEW MARKETS.

Q: What are the Participatory Research Appraisal (PRA) tools developed by MicroSave?

MicroSave's participatory research appraisal tools are qualitative tools for market research, based on participatory data collection. Although the number of tools available can seem overwhelming, it is not the role of the Credit Officer to use them in conducting market research. Most Credit Officers would not be responsible for such an in-depth analysis of the market.

The process of using PRA tools is as much important as the outcome itself. The tools cannot be used without setting them into a particular context. *MicroSave* spell out and format tools for example, are designed to be used in conjunction with a series of focus group discussions that are used to probe specific areas of interest arising from the research issue and the PRA work. It is neither feasible nor desirable to prescribe exactly which qualitative research tools should be used for any given situation. Rather, a well-defined institution and an environment-specific formulation of the *research issue* should allow practitioners to do that.

Furthermore, many of the PRA tools can be used in different ways, according to the research issue. The simple ranking tool for example, can be used in a wide variety of ways, from ranking the importance of different attributes/components of the MFI's products (interest rate, weekly meeting, grace period, repayment period, etc.), to reasons for dropping out from the MFI's programmes.

Q: What is outreach?

Credit Officers cannot sit behind a desk and expect clients to come and find them (a common problem). Ways to achieve successful outreach include (Thomas and Tsilikounas, 2004):

- **Mass media advertising**
  - Print: free and paid newspapers
  - Yellow pages
  - Billboards: bus, tube, etc.
  - Radio
  - TV
  - Internet

- **Targeted advertising**
  - Direct mail campaigns
  - Description of recent loans sent to potential customers/referees
  - Displays at MFI branches
  - Inserts in utility bills, bank statements
  - Point of purchase materials at client businesses

- **Public relations**
  - Successful entrepreneurs profiled in local papers
  - Appearance on radio and/or TV show

- **Referrals**
  - Existing clients
  - Staff
  - Banks
  - Enterprise/business advice centres
  - City council/chamber of commerce
  - Community-based organisations
  - Social services programmes
  - Job centres/place where the unemployed go to collect benefits

- **Community outreach**
  - Contacts w. community centres, job centres, libraries, etc.
  - Housing associations/local authorities
  - Church/organisation leaders
  - Local colleges

- Block walking
- Leafleting streets/estates
- Public speaking at community events
- Community-based promoters

- **Direct marketing to target clients**
  - Orientation/information sessions for potential clients
  - Free seminars on "how to finance your business"
  - Introductory video for potential clients
  - Creating a Credit Officer marketing budget

Some MFIs give rewards to current clients for referring new clients. This is a cheap and easy way to build their client base with little cost to the MFI for advertisement.

Tracking Information

In developing the best marketing methods for attracting new customers to a MFI, it is crucial to track results. *Why?* Because that is how one finds out which types of marketing are bringing in good clients. From this information, one can concentrate efforts on the most successful methods.

Screening forms should ALWAYS involve asking how a new customer heard about the MFI and product. It should become a habit of Credit Officers to ask new customers how they heard about the MFI.

Q: What are some means to improve communication? What is a tagline?

A **tagline** is a short slogan that seeks to communicate key product messages to the customer. It must reflect a need and be descriptive about the product. Customers do not buy products and services: they buy **benefits** or **value** they expect to derive from the products. It is therefore important to list the key product attributes and translate them into benefits for the customer.

Q: What is a USP?

A product's **Unique Selling Proposition** (USP) is "the difference that makes the difference" between your MFI and your competitors. The USP should be as tangible and factual as possible. Some MFIs may have several USPs related to different market-responsive products.

Always be suspicious of a USP phrased as "We provide the best customer service" and always be aware that your customers do not seek products, but individual benefits.

Q: How do you, as a Credit Officer, measure your outreach effort?

Outreach **effectiveness** has two dimensions:

1. The number of all enquiries that comes from a source

2. The percentage of the enquiries that get converted into loans is known as *enquiries to loans conversion ratio*

Outreach **efficiency** includes the notion of value for money. How much does this strategy cost (includes cost of time to employ the strategy, not just the cost of paying for the leaflets or radio advert) and is it worth it given its yield? The cost includes the time required to employ the strategy, not just the cost of paying for the leaflets or radio advertisement.

Not many MFIs do this, but it would involve tracking where enquiries are coming from, in addition to the enquiry to loan conversion rates.

Look at the table below and ask yourself:
1) What can we conclude from this?
2) Why could these differences exist between the effectiveness of various methods?
3) Is there any other information you would like to know about this institution?

	Cost (Ksh.) of campaign	# clients	**Cost per client**
Radio	750,000	2,503	299.6
Posters	20,000	126	158.7
Billboards	100,000	345	289.9
Pamphlets	50,000	245	204.1
Personal Selling	250,000	1,759	142.1

Possible answers:

1. It could be concluded from this table that radio is the most costly type of outreach/promotion at almost Ksh 300 per client, and that personal selling is the most inexpensive at half that cost per client for this MFI. This would indicate that it may be more appropriate to focus on personal selling and pamphlets. These aspects will be discussed as a conclusion to the topic.
2. These differences can exist for two reasons: a) culturally, one means of outreach will be more appropriate for one segment of a population than another, and will also vary depending on the location (remote versus urban setting); b) although one type of outreach method is appropriate, the campaign itself may not be designed. Ask participants if they can think of any example of this.
3. Information that may be interesting includes:
   - For certain types of promotion, there is a threshold above which costs go down and an institution can still draw more clients in (sort of like a fixed cost level). For example, it may be that once you have invested so much in radio, then people know about the jingles at a specific time, and this will draw more customers (to a certain extent of course, given that the potential market reached by each channel is finite).
   - Comparing actual campaigns in relation to the institution's mission statement and key products, so as to determine how effective and sound they are. Viewed in isolation, they may not provide much information.

Concluding remark about this exercise: personal selling represents direct outreach from Credit Officers. This is ESSENTIAL to the effectiveness of the outreach method.

Q: What are the advantages of personal selling, direct outreach and referrals?

Advantages of personal selling, direct outreach and referrals (*MicroSave*, 2004):

- Gaining acceptance of new products by existing customers
- Attracting new customers for existing products
- Maintaining customer loyalty – demonstrating care
- Facilitating future sales by provision of advice to prospects or influencers
- Gathering market information
- Providing a basis for dialogue and offering a focused approach with immediate feedback

Personal selling is about:

- ✓ Setting consistent standards and approaches
- ✓ Defining rewards/incentive schemes
- ✓ Setting targets by team, region and person – ensuring buy-in from sales team, or selling the product to the sales team
- ✓ Providing an opportunity to educate clients
- ✓ Producing sales support materials in:
    - ✓ Clear,
    - ✓ Concise,
    - ✓ Client language
- ✓ Being effective in a competitive market
- ✓ Making sure that it is easy for the prospect to buy

Q: In this context, why is it important how Credit Officers treat their customers?

It is important for Credit Officers to treat their customers well for the following reasons:

1. Credit Officers are the first point of contact with the customer and build the MFI's reputation.

2. Marketing experts have long demonstrated that it costs five times more to get a new customer than to keep an old one. Financing relationships are built on trust between the customer and the MFI. Trust takes time to create, and it is done through creating a polite but friendly and comfortable working relationship with customers. The customers of a MFI should be seen and treated as its assets.

3. Contented customers are willing to refer others to the MFI. Conversely, clients that have been treated poorly are likely to tell their friends and business associates about the poor treatment they received. Further, they are more likely to tell their peers about a bad experience than a good experience. This is another reason why Credit Officers' knowledge and behaviour towards clients is so crucial!

4. If the customers feel the MFI is treating them well, this increases their desire to be a good customer. This means higher repayment rates and more deposits.

Q: What are the essential skills that Credit Officers should display in order to ensure that customers are well treated?

1. All salespeople need to deploy a triple combination of skills that blend into a persuasive approach**:**
2. **Service**: This is paramount. Everything from being prompt for a meeting to ensuring reliable after-sales service matters
3. **Technical excellence**: In product knowledge, for instance. Nothing less than 100% proficiency will do here. Anything less will be noticed and will dilute effectiveness.

4. **Sales skills**: The details of the many techniques that contribute to a persuasive approach must be actively built into your approach.

Ten rules of customer service:

1. A polished first contact with any potential customer. As we say in English, "You never get a second chance to make a first impression." So, at the first meeting or on the telephone, the Credit Officer should try to create an image of efficiency and friendliness from the outset.

2. Always be polite with any potential customer. Even applicants who are ineligible can speak to others who are potentially good customers, so it is important that they have a pleasant image of the MFI.

3. Always be prepared for a meeting with a client. Before holding a meeting or making a visit to the customer's premises, Credit Officers should make notes of what they must achieve in this meeting.

4. Professional presentation: part of maintaining a professional and helpful manner means not reacting negatively if a customer makes a claim that is incorrect. The Credit Officer's main role is to listen and evaluate.

5. When asking a customer for information on his business, be careful how you phrase your request. To obtain the information necessary to make a loan decision, the Credit Officer often needs to investigate the real workings of a customer's business. This is usually best obtained through a relationship of trust with the customer. This trust can be easily broken by asking questions undiplomatically.

6. Do not create false (unnecessarily hopeful) expectations. It is important not to promise a loan before the Credit Committee has approved it. Likewise, customers should be told how long they will realistically have to wait for approval and disbursement. If you make an appointment at a certain time, make sure you will be ready with what they need. Constantly communicate as to what is needed from the customer so there are no misunderstandings. If it looks as if you will have to decline the customer's request, do it as quickly as possible and explain the reasons so that they can understand and maybe apply again if and when the situation has improved.

7. Preserve confidentiality. Don't discuss a client's situation in the presence of other clients. It is important to preserve the confidentiality of information provided by borrowers. Confidentiality is an important duty of financial institutions. Don't discuss internal issues about your MFI in front of clients. Credit Officers represent their MFIs and should not involve clients in internal questions that can harm the reputation of the MFI.

8. React quickly to the requests and needs of the customer. This lets the customer know that s/he is important to the MFI.

9. Approach client complaints in a professional manner. If customers have complaints, deal with them calmly. Remember that an unhappy customer talks to twice as many people as a happy customer. Even unhappy customers can be brought back to satisfaction if their complaints are heeded. There may or may not be something the Credit Officer can do to resolve the customer's problem, but just listening, sympathising and if necessary, apologising can help a lot.

10. Rejections: be pleasant but firm. It is important to explain why a loan has been refused clearly and avoid promising future prospects of a loan unless the customer has a good chance of getting a different decision next time.

Q: How do you become a good facilitator while remaining courteous, responding to potential customers' needs and not being too aggressive?

The key is in knowing how to listen. It is all about communication. This is what happens: A message is sent from the sender to the receiver.

Sender -> message -> receiver

The problem is that when we meet new people, we do not only focus on what they say (verbal communication) but we also make an opinion based on HOW they say it: body language or non-verbal communication and volume or speed of speaking which is called Para-verbal communication.

The second problem is the reason why customer service is challenging: communication is always distorted. Sometimes the receiver hears something different from what the sender is saying (different meanings). The meaning of a message is always personalized to a certain extent (words have different meanings for different people). In addition, the speed of thoughts is much higher than then speed of speech, so it makes it even more complicated to say all of the things we would like to say. Good listening can lower the risks of distorting the information sent to the Credit Officer and back.

Listening is essential:
- Customers want to deal with people who take an interest in their situation.
- However, listening is an active process, and Credit Officers must be good listeners.

Active listening means careful listening, focusing and using one's body language to listen better.

Q: How should you handle difficult customers?

The aim of marketing is to bring good, new customers into the MFI. However, no Credit Officer escapes having to deal with difficult customers. While you may display complete courtesy and good listening skills, difficult customers will always be around. It is important to be able to calm them down and maybe even turn them around. For example, the customer who does not want to talk, or the customer who won't stop talking! Then there is the customer who does not want to repay, or the customer who is unhappy with the way s/he has been treated by the MFI.

What should you try to do?
- To neutralize their bad feelings, if possible
- To give them the best possible service in the shortest possible time

How should you do this?
- ALWAYS remain calm
- Try to clearly explain WHY if you cannot help the customer
- Do NOT blame mistakes on other staff of the MFI
- Be FIRM but POLITE

Q: What conclusions can you draw about the work of promoting and communicating with customers?

- It is challenging
- Communication cannot be taken for granted
- The job is never the same! And it is quite exciting!

- Without skilled Credit Officers, all the effects of a well thought-out marketing strategy can potentially go to waste!

CREDIT OFFICERS ARE ESSENTIAL TO THE INSTITUTION'S MARKETING PLAN!!

Because they are essential, it is important for them to keep track of their role and effort in marketing. For this purpose, some institutions have created individual marketing plans for Credit Officers.

Q: What is an individual marketing plan for a Credit Officer?

Some institutions may use Marketing Plans to reinforce and monitor Credit Officer marketing. They help Credit Officers see if they are meeting their plans and review which marketing strategies are working well. These plans can help the Credit Officer manage his/her own time between marketing, analysing, and monitoring loans.

Credit Officer marketing plan

Credit Officer Name:			
Branch:			
Today's date:			
Previous review date:			
Next review date:			
Responsibilities and reasons	Prior goal	Actual Result	Planned Action
Organize and facilitate one information session per week			
Distribute 100 leaflets in village XX			
Cold call 20 businesses			
Etc.			

Example of Marketing Techniques for Credit Officers and MFIs:

The Credit Officer at Association of Cambodian Local Economic Development Agencies is the main person responsible for the marketing the loan products, although the Marketing Department provides promotional materials, such as product brochures and flyers.

Initially, the Credit Officer will conduct a business or market survey to determine business potentials and opportunities of the area. They also schedule meetings with local community through the local authorities and seek their assistance in solicitation of accounts through house-to-house campaigns in the village or commune. Promotional materials on the loan products are distributed during these meetings.

Each Credit Officer is given a monthly target for loan disbursement, based on the initial business of mapping potential clients conducted by the branch. Actual accomplishments versus planned targets by each branch are reported every month as part of the MIS report. There is a branch incentive program in place and top branch performers are recognized at the end of the year. Based on the Bank's profitability, they are given bonuses, which may be equivalent to two months' salary. On the other hand, top individual performers are given 2-3 steps promotions.

(ShoreCap Exchange, SME Training, Manila, 2005.)

Red Flags:

- Think of marketing from the very beginning of the lending programme. "The major errors in most MFIs are made prior to opening the doors. They have not done enough up-front analysis of their clients." (Development Alternatives, 1999)

- Listen to the clients and be prepared to throw out some of the core beliefs that you had at the beginning of your programme." (Development Alternatives, 1999)

- Make sure that the marketing effort is used in an effective manner. Do not waste time and money on certain outreach and advertising strategies. Know what works best for your clientele.

- Do not underestimate the training needed to listen to clients properly and especially to deal with problem customers.

- Do not get caught wasting time looking for a USP, brand name and tagline and not understanding the differences between them. Mainly remember what the lending product stands for and who your clients are – these are the most important things.

Customer Driven:

Association of Cambodian Local Economic Development Agencies has a **wide mix of loan products and financial services that are customer driven and delivered through a high level of quality and timely service.** Based on records, the bank has a high number of repeat customers, indicating that many customers are satisfied. Their tagline is ***"customer service oriented at all times."*** The Bank continuously develops financial products or services that are attuned to the customers' businesses and financing requirements. Similarly, the Credit Officers and staff are trained to provide quick service and be ready to assist customers in all types of bank products and transactions. In the same manner, the Credit Officer assists the client not only in the preparation of their business plan and loan applications, but they are also expected to provide basic advice to their clients on business and financial management.

Marketing is an on-going process. It is not a department; it is the MFI's business.

Session 4: Credit Analysis

Q: What is Credit Analysis and why is it important to us?

Lending is the business of taking risks. Every loan implies a certain level of risk. The principal risk for Loan Officers is called credit risk: the risk that the borrower may not meet the terms of the loan and that secondary sources of repayment, such as collateral or other family income will be insufficient to cover the losses. Loan officers are there to understand and manage risk, not to avoid it or deny it. Credit analysis is the process of understanding and analyzing the credit of a customer as a means to evaluate the level of credit risk they represent. The Loan Officer is responsible for this process. The result of the process is usually a conclusion that is presented to the decision makers about whether or not to make the loan. Credit analysis helps us define the level of risk and evaluate whether it is a risk worth taking.

When thinking of credit, one can try to understand and get information about the 5 C's: character, collateral, capacity, conditions and capital. Each one of them is critical to good credit analysis for high microfinance performance. This section focuses on character and a later section will provide guidelines on conditions.

Remember: Lending is both an art and a science.

Part of the "Art" of lending is in:
- Making credit decisions based on complete information
- Understanding the motivations and character of your customers
- Building trust with your customers to help motivate repayment

Part of lending is also "Science":
- Obtaining the facts of the loan request (what is going on here?)
- Analyzing the information to tell the real story
- Preparing a cashflow and calculating repayment capacity

.

As you have learned in the loan process, the first step is to find out the key information regarding the customer's request. This is the bare minimum to assess eligibility of the borrower/ business:
- Loan amount requested and loan use
- Information about the borrower (company, individual, partnership)

Once you have ascertained that the borrower is eligible, move on to assess the 3 M's. The level of risk depends on several factors about the specific business. These can be summarized into three main categories, known as the 3 M's: Management, Money and Market.

Market: Is this a good business opportunity? Is there a market? Are there customers?

Management: Is this the right business owner for the business. Is he/she a good fit? Is he/she reliable?

Money: Is this the right amount and structure of financing? What future sources of cash will the customer have to repay?

Q: Regarding the market, what is some information that we need to collect?

Basic market-related topics for credit analysis:

- Products and services
- Competition
- Suppliers
- Business location
- Production
- General market strategy

More detailed information about each category:

Products and services:

- What do they sell and what is the demand for this product or service?
- What is the quality of the product and can it be copied by others?
- How is price determined, and how do competitors price their products? Is it easy or difficult to raise prices?

Competition:

- Who are the business's competitors?
- What advantages/disadvantages does the business have over competitors?

Suppliers

- Are there any irreplaceable suppliers?
- What is the applicant's status with current suppliers? In good standing?
- What is the certainty of the supply sources? Threats?

Business location:

- Will population density and demographics support the business?
- Is traffic flow good? Is it a destination product or an impulse purchase?
- Is transportation or access to the location a factor?

Production:

- How will the borrower make or deliver the product?
- What is the technology? Is it reliable? Are changes needed or expected?
- How many employees are required? What are the required skills? Can the business find these skills?
- Are quality control systems in place? Is quality a concern due to high returns?
- Are inventory levels reasonable?

General market strategy:

- Does the business have a well-defined and potentially profitable market niche?
- Is the competitive advantage defensible?
- Does the microentrepreneur have a good understanding of the market and how to compete?

It is very important that the Credit Officer asks the questions in a way that will draw out the most information from the client. For example, if a Credit Officer says, "You don't have another loan, do you?" The client is more likely to answer 'No', in order to get a loan. A better way to ask this question would be, "Having a previous loan (or credit history) can help you get a loan with my MFI. Do you have a current loan outstanding or have you ever taken a loan before, even from a money lender or relative?" There will be more on this subject later in this session.

Q: Regarding management, what do you think are good qualities for a business owner?

The Manager should have the right demeanour and character and be suited to the business. For example, if one is heavily involved in selling, it helps to be a good sales person and not a shy individual, who is terrified of approaching potential customers. A good Manager can make an average business opportunity successful. A poor Manager will fail at even the best business opportunity. Management is the most important factor in whether a business idea is successful, because the Manager can make the business work by finding new customers, or finding new ways to solve a problem. Less experienced borrowers should stick to businesses with which they are already familiar or have experience, and grow them gradually.

Some criteria for potential borrowers include:

1. Skills: Do they have the management skills needed for this business?

- Experience related to this business and time spent working in the business
- Track record in the business
- Experience in a supervisory position
- Skills related to the business, such as accounting, management, finance, technical skills for the particular job

2. Do they have the personality and commitment to repay?

- Personal credit history patterns and behaviour to meet obligations
- Community responsibilities and roles that indicate commitment
- Quality of business plan and focus on the details of the business

3. Dependence on owner's draw and household income sources

- Are there other sources of income for the household (another earner)?
- How dependent is the owner on his/her draw to meet personal obligations?

Q: How can the Loan Officer check the character of a borrower?

References and people who know the borrower are essential, as well as evidence that the borrower knows the business well.
Sources of information for a character reference:

- Customers
- Suppliers
- Employees
- Neighbours
- Banks
- Community/church leaders
- Documentation
- Site visit

Q: Regarding the last 'M' of credit analysis (Money), what do we want to know about the borrower?

Credit Officers are interested in finding out if this is the right financing and use of loan funds. In order to do so, they will analyze the cashflow projections. There will be a complete session on completing and analysing the cashflow and on structuring the loan. Therefore cashflow and loan use are only briefly presented here.

When reviewing the financial aspect of a business, the Credit Officer will ask several questions, such as:

- Is there a need for more working capital?

- How long is the cash cycle or operating cycle of the business?
- How realistic are the growth projections of the business owner. Have they underestimated or overestimated sales figures?
- Is this the right amount of financing? Can we reduce the amount? Do we need to increase the amount?
- Can the borrower manage a larger cashflow associated with receiving a larger loan?

The cashflow will help answer the following question:

- Can the business repay the debt payments of principal and interest?

Q: Why do you think the use of the loan is important for Credit Officers in their credit analysis?

Understanding the loan use is important because:

- It will affect the ability of the owner to make repayments and, therefore, it will affect the risk associated with the loan.
- It will tell you how soon that investment can produce cashflow for the business and a loan instalment for the branch.
- It may tell you how the owner is paying her employees (and her own) salary. Is it coming from the cashflow of the business or is she using the loan to fund this amount?
- Understanding how the owner plans to use the funds tells you something about the owner's level of skill, how the owner is thinking, and what s/he is prioritizing.

Thus, it is very important to ask and understand specifically how the loan proceeds will be used. Will the money be used to purchase equipment or raw materials? How soon can the investment produce cash for the business and repay a loan instalment to the bank? The employees' and owner's salary should be paid from the cashflow of the business, not with the loan funds. The owner's salary should be drawn after the loan instalment is paid.

> If loan proceeds are not used for their intended purposes, there could be problems with repayment. For example, if a client claims that loan proceeds will be used to buy working capital (inventory for his/her store) and the funds are actually used to purchase some furniture for his/her house, there could be some repayment problems, as the client has diverted revenue producing assets to non revenue producing, personal assets.

Question	**Factors to Consider**
Market: Is this a good business opportunity?	
1. Product	What is the product or service that will be sold? How will the borrower make or deliver the product or service? What components go into making up the product (check out the inventory)? Who supplies the inputs?
2. Customers	Who will buy this product/service and why? Do we know they will buy it at this price? How will you find/reach customers? Is there a concentration of customers? Do the customers buy on credit or for cash What are the terms and quality of the a/c receivable like?

3. Competition	How many other businesses in the village/town? What other products do customers buy? Why will people pay for your product/service? What is the advantage? (Location, price, new technology, middleman, fashion) How easily can advantage be lost (new bakery opens in village)?
4. Cashflow	Are all costs (including the weekly loan payment) identified and estimated realistically? Are revenues realistic? How much need to be sold each day/week to make loan payments? Realistic? Is cashflow sufficient to cover the weekly, biweekly or monthly instalment and still leave a profit for the borrower?
5. Character	Does the borrower have a strong history of on-time repayment and good savings deposits records? How strong is the borrower's personal commitment to business (how much personal investment?
Management: is this the right borrower for this activity?	Right skills for the type of business? (Selling, attention to detail, numbers, design) Experience in same or similar business, or first time with this type of business? Strong common sense? Willing to listen to advice?
Money or Financing: is this the right amount for the loan?	Is this too much money for the planned business? Is this enough money so the business will not fail? (e.g. if she sells on credit, needs more money) Are weekly or biweekly payments reasonable given the cashflow from the business? Is it the right loan use?

Q: What are the steps in the process for individual lending, from initial contact to disbursement?

In the step-by-step overview (refer back to **Session 2 Step-by-Step**), various forms were briefly presented. This session will go through them in greater detail, so that Credit Officers can understand what they mean and how to use them.

Q: What is the Screening Form and why is it helpful?

The applicant first meets with the Loan Administrator or Credit Officer, depending on the function in each organization. The client screening form is a one-page tool that helps get through the initial interview as quickly and efficiently as possible. It also aids in weeding out clients who are eligible for a loan, from those who do not have a good chance of getting a loan (because they have no business activities or cashflows, for example).

If the steps are not completed in order, the lending process will not be as efficient and risk-free as it was set up to be. For example, if the Loan Officer does not check that collateral is registered properly before the loan is disbursed, there may be problems at a later stage. Following the steps in the right order is not the only factor affecting efficiency. The MFI should also ensure that it has found the best and most efficient order to the steps for their purposes. Additionally, if Credit Officers do not follow the MFI's procedures and policies, there may be unforeseen risks and problems. For example, if the client's age is not verified, a loan could be disbursed to a minor. This could cause problems as a court would not uphold a contract with a minor.

Q: How do you actually conduct the screening?

The screening should take no more than 15 minutes. Screening is like an interview between the potential borrower and the administrator (or Credit Officer, depending on the institution). It is best to have the administrator carry out this task because it saves time for Credit Officers, who usually spend quite some time out in the field and are sometimes hard to reach at the appropriate time. Concretely, the following steps take place:

1. The administrator (or Credit Officer), after presenting briefly his/her MFI to the potential client, explains that the institution needs to capture key information about the borrower. The administrator explains that the MFI has well-defined selection criteria and needs to ensure that the applicant will satisfy these. Conversely, explain that this process will be helpful, as it will make him/her think through the business idea and see if there is a real desire to pursue it.
2. The administrator explains that s/he will ask a set of questions and then write the responses. For sensitive questions, such as credit history, it is important to clarify why being honest and open about the response will be better for the borrower than changing the figures or hiding information. Some verification of this information is achieved by checking it several times through various means and sources. It is better to provide the most complete information if it is available and known. The institution has a specific way of determining for example, the approved loan size and it may not be beneficial to knowingly state a lower or higher income.
3. The potential borrower will then be asked to check that what was written on the form is correct before leaving it with the institution.
4. The administrator (or Credit Officer) fills in their name, signature and date in the bottom box.

NOTE: To save time some institutions have the applicants complete the screening form and then go through it with them in the office immediately afterwards. This is not advisable because a great deal of information is gained during the screening process.

Q: What information are you trying to obtain in the initial screening?

The Credit Officer is trying to quickly obtain information to prove if the client is eligible for the product or not. They are not trying to get all the information. This will be done later in the loan appraisal and cashflow analysis.

If the client fits the eligibility criteria, an application should be given immediately. The client completes it in the office and then a site visit is scheduled. Some MFIs have information sessions and/or have the client bring the application back later, but this lengthens the process. Too much back and forth makes the process inefficient.

In some cases Information Sessions work well for advertising a MFI's products and gathering new clients. This is usually the case in environments where the Credit Officer can gather large groups of people in a new region where the MFI has not operated previously. In areas where the MFI and its products are well known, Information Sessions can be inefficient and unnecessary.

EXAMPLE of an Individual Lending Screening Form:

Screening Form #: ____________________ Date: ________________, 2004

Please ensure all the questions have been answered below before giving the client an application.

General information

1. Applicant's Name and Age: ____
2. Home telephone: ____
3. Applicant's Address: ____
4. Marital Status and Number of Dependants: _______________________________

Business information

5. Business Name: ____
6. Business telephone: ____
7. Business Address: ____
8. Type of business: ____
9. How many years have you owned this business, excluding periods of inactivity? _______
10. Is the business currently running? □Yes □No **If not, period of inactivity:**_______months.
11. Company's Legal Status: _________________**Registration # and date**: # _________ & ____/____/___
12. Number of owners: ________**Names:** ____
____
13. Present number of employees: _________________
14. Does the client have other sources of income other than the business in question? □Yes □No

Desired loan

15. Project Purpose: ____
16. Project Amount: Ush _________ Owner's Contribution: Ush______________
17. Loan Amount: Ush__________ **Term:** ______**months**
18. Projected number of employees after the loan: _________
19. Do you currently have any type of debt? □Yes □No
20. If not, have you ever taken a loan that you have already repaid? □Yes □No

Other

21. Where did you hear about the Loan Program ? (check all that apply)
Brochure ☐ Advertisement ☐________________ Friend ☐ Bank ☐ Other client ☐Other bank ☐____________ Other: ____________________

ELIGIBILITY CRITERIA VERIFICATION				
Client > 18 year	Ugandan citizen	National ID with correct name, spelling and ID #	Permanent Business Location	In same business as that of the loan request for at least 6 months
☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
ACCOUNT OFFICER NAME: SIGNATURE: DATE:				

Description of the Individual Lending Screening Form

General information

1. **Applicant's Name and Age**: full legal name and age of applicant.
2. **Home telephone:** if any, home telephone number or any other number where the applicant can easily be reached.
3. **Applicant's Address**: current residential address of applicant.
4. **Marital Status and Number of Dependants**: indicate whether the applicant is single, married, widowed or separated. Indicate number of family and other household members, who are financially dependent on the applicant. **This will be important when determining the household expenses in the process of calculating the debt capacity.**

Business information

5. **Business Name:** indicate if the business has a duly registered business name. If the applicant operates from his/her residence, write the address of the residence or indicate, "same as residence".
6. **Business telephone:** if any, telephone number that is being used by the business. Indicate if this number is the same as the residential telephone.
7. **Business Address:** indicate the business address
8. **Type of business:** the nature of the business the applicant is engaged in. For example, is it a retail, market vending, eatery/bakery, transportation, fishing, food processing, crafts and light production, agriculture processing, or personal services?
9. **How many years have you owned this business, excluding periods of inactivity?** How long, in terms of years, has the applicant been operating his/her business? This is an indication of the degree of experience and skills for running this business. This skills assessment is part of determining the risk of lending to this applicant.
10. **Is the business currently running?** Is the business in operation? If not, what is the period of inactivity **-** the period during which the business has not been in operation (specify in months or years**).** This information helps to determine how updated the applicant is in terms of changes in the market, competition and new technology. If the business has been interrupted for a while, it will be important to find out why. Was there a lack of funding or profit

margins? Did the business owner need to leave the area? Make sure not to appear as though the business should be running. Just say that you are interested in knowing what has happened to them in the past and were they able to keep their business running?

11. **The company's legal status**: indicate if the business is a joint ownership, sole proprietorship or other form of business**.** Provide the registration number and date of registration
12. **Number of owners and names:** If business has several owners, include the total number and full names.
13. **Present number of employees**: number of paid persons working in the business.
14. **Does the client have sources of income, other than the business in question?** Indicate whether the applicant or household has another secondary business activity, other than the main business. This is important in determining the credit risk. The Credit Officer should say that he is interested in him/her as an individual, not only in the one business for which he is seeking a loan.

Desired loan

15. **Project Purpose: t**he business activity for which the loan is going to be used and how it will be used. The applicant here should have a clear sense of why the loan is needed. Therefore, if the response is unclear, it is important to probe by asking questions: "What will you do differently with the business after you receive the loan?" "If you get the loan tomorrow, what will you do with it?" "Why and how will this be good for your business ultimately"?
16. **Project Amount:** the total amount required for the business idea**. Owner's Contribution:** the amount that the applicant can invest in the project without external support.
17. **Loan Amount:** the amount the applicant wants to borrow. **Term**: the time that applicant would like to have to repay the loan (in months)
18. **Projected number of employees after the loan**: if the loan implies an expansion in the business, the projected number of paid employees should be specified.
19. **Do you currently have any type of debt?** Indicate if applicant has any current debts with any person or lending institution. If known, obtain information regarding the name of the organization, loan amount and loan term. It is important to tell borrowers that "credit history / prior loans" can help them obtain a loan. Mention that debt is evidence of capacity to repay a loan, and knowledge of how the lending process functions, so he/she should be as open as possible.
20. **Have you ever taken a loan from a relative, friend, money lender, MFI or bank?** Explain the positive side to having credit history, as per question 19.

Other

21. **Where did you hear about the Loan Program?** This is for marketing and tracking purposes within the MFI and was covered in *Session 3*. The Loan Officer / applicant should check all that apply: brochure, advertisement, friend at the bank, another client, another bank or other source.

This section is a summary of the important eligibility criteria. The Credit Officer would cover these issues and make a quick decision: if yes, give them an application. If no, reject the request immediately and respectfully.

ELIGIBILITY CRITERIA VERIFICATION				
Client > 18 year	Ugandan citizen	National ID with correct name spelling and ID #	Permanent Business Location	In same business as that of the loan request for at least 6 months
☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
ACCOUNT OFFICER NAME: DATE:				SIGNATURE:

Q: What is in the Application Form?

The simple one-page Application Form is completed by the client and is comprised of personal information, business information, and loan information.

SAMPLE Individual Application Form:

BRANCH:	ACCOUNT OFFICER:	A/C Type and No.:	Balance:
CLIENT IDENTIFICATION NUMBER (CID):			
PERSONAL DATA			
Name:		Nickname:	
Identification Number:		Type of ID:	
Passport No:		Driver's permit No:	
Home Address:		Number of years at this address:	
Telephone (home and cell):			
Date Of Birth:	Age:	Place Of Birth:	
Client's Occupation:		Client's Education:	
Sex: ☐ Male ☐ Female		Marital Status: ☐ Single ☐ Married ☐ Widowed ☐ Separated	
Name Of Spouse:		Occupation Of Spouse:	
Number Of Dependents:			
Home Ownership: ☐ Owned ☐ Rented ☐ Mortgaged ☐ Shared/Others			
BUSINESS ACTIVITY			
Type Of Business (Retail, wholesale, service, manufacturing):			
Business Name:		Business Address: City Division Parish Zone Street	
Business Telephone:		No. Of Years In The Business:	
Business Partner (If Any) and ownership %:		**No. of Employees:**	
Estimated Business Assets:		**Estimated Monthly Sales:**	
Is your business registered/licensed? ☐ **Yes** ☐ **No**	**Sole Proprietor/Partnership/Limited Company/ Cooperative:**		**Registration/License No.:**
Who looks after your business when you're sick or away?			
Are you involved in any other business activity? ☐ Yes ☐ No If yes, what type of business?			
Are you employed apart from owning a business? ☐ Yes ☐ No			
Status Of Employment: ☐ Regular ☐ Contractual ☐ Others		Monthly Income from Employment:	
Name Of Employer:		Telephone of Employer:	
Address Of Employer:		Name of Manager:	
LOAN INFORMATION			

How much do you want to borrow? __________			For how long? ________ months		
Purpose of loan?			How much can you afford to pay? ____________________ monthly		
Household and Business Assets: (continue on back if needed)					
Item	Year produced	Model & Brand Name	Acquisition Date	Acquisition Cost	Current Estimated Value
1					
2					
3					
4					
5					
6					

Do you have any outstanding loan? ☐ Yes ☐ No	Does your spouse have any outstanding loan? ☐ Yes ☐ No
If yes, how much is your outstanding loan? __________	If yes, how much is his/her outstanding loan? ________
Name Of Creditor/Supplier:	Name Of Creditor/Supplier:
Name at least one creditor/supplier that you have borrowed from in the past (this will help you get a loan): 1. 2.	
Any current or savings accounts or deposits? ☐ Yes ☐ No	If yes, Amount? Name of bank or institution?

AUTHORIZATION

I confirm that the above information is true and correct to the best of my knowledge. I am aware that any false statement may be an immediate cause for denial of this loan. In connection with this application, I authorize the MFI to obtain such other information as may be required. This authorization includes obtaining information from suppliers, commercial banks, rural banks, and all other creditors while releasing these institutions from liability under any and all bank secrecy laws.

Also, I agree abide by MFI's policies, rules, and regulations.

SIGNATURE OF APPLICANT ______________________________ DATE/PLACE ____

SIGNATURE OF SPOUSE ________________________________ DATE/PLACE ____

Individual Lending Application Form - Description

New information, not included in the screening form, is required in the following categories:

Business activity section:

- Estimated Business Assets: estimated amount of the business's total value, including cash, collectibles, inventory, and fixed assets.
- Estimated Monthly Sales: estimated amount of income from business sales every month. If sales are generated on a daily basis, this amount should be multiplied by the number of days the business is open within the month.
- Who looks after your business when you are sick or away? Explain what arrangements are made for managing the business in the applicant's absence.

Loan information section:

- Loan payment: how often can you afford to pay? How frequently can the applicant pay his/her repayment: weekly, biweekly or monthly?
- Loan payment: how much can you afford to pay? How much can the applicant pay if he/she chooses to pay weekly, biweekly or monthly?

Household and business assets: include both household and business assets, such as appliances, inventory and other chattel items. Go through these assets one-by-one.

- Acquisition date and cost: date of purchasing asset and value at the time of purchase.
- Current estimated value: the present market value of the assets mentioned.
- Name at least one creditor/supplier that you have borrowed from in the past: if the applicant has no outstanding loan at the time of the application, but had previous loans in the recent past, the applicant should supply the name(s) of the creditor/supplier for credit investigation purposes.

Q: How do you evaluate the application form? Tips for evaluating the application.

The Loan Officer reviews the application and asks the applicant questions in the branch or later over the phone. The Credit Officer should focus on determining whether or not the screening form and application form are consistent and realistic, in terms of estimated sales, as compared to the type of business and assets, or in relation to the business seasonality. It is also important to cross-reference the loan amount requested and the amount affordable per month with monthly income, to see if both are reasonable and realistic. This section is part of a session on loan structuring and cashflow analysis.

Both screening and application forms together enable the Credit Officer to:
- obtain more exhaustive information about the business
- check that the applicant is consistent in his/her responses
- recheck whether or not the business is in line with the institution's eligibility criteria

Reminder: if the client fits all the eligibility criteria, the administrator or Credit Officer cannot reject the client on their own. The Loan Officer and supervisor identify which outstanding issues remain and decide whether to continue with this client. If they decide to proceed, the Loan Officer starts a file for the client and completes a loan analysis.

Q: How does the Credit Officer check the information on the application form?

As soon as the application is returned, the Credit Officer should schedule a site visit for the same day or the following day to the client's business and residence. The purpose of the site visit is to check whether the information provided by the client in his/her screening and loan application form is correct, to gather information about the client's character and credit history, and to analyze the client's cashflow and debt repayment capacity. The Credit Officer also needs to inspect and appraise the assets that could be used for security and collateral.

It is very important that Credit Officers complete a through site visit for each client before the loan is analysed and disbursed. In some cases, the Credit Officer chooses to skip this step, in the interest of saving time. This is particularly the case for repeat borrowers, with whom the client has spent a lot of time and has established a level of trust. It is possible, however, for the client to become a problem later in the relationship. This could be avoided if the Credit Officer goes on a site visit and sees, for example, that the equipment is not functioning, the inventory is depleted, the business has moved to a less favourable location, or the Manager had been laid off.

The Credit Officer should plan the first interview at the client's place of business. Conducting the interview there serves two purposes. First, it puts the applicant more at ease (because s/he is in a familiar setting), giving the Credit Officer an opportunity to observe first-hand the inner workings of the business. Second, an on-site interview gives the applicant and the Credit Officer some common ground from which to assess whether or not and how the bank may assist with working capital through a loan.

The Credit Officer should have a very thorough look around the premises. Look for untold clues as to the behaviour of management. For example, what are the conditions of the bathrooms, lunch room, outdoor areas, behind the building, inventory and storage areas, behind the counter, under the food and cans on the shelf, inside the freezer, back up for electricity and expiration dates of perishable items.

A visit to the applicant's residence should also be performed, whether located next to or separately from the business. The account officer should be able to determine the applicant's type of housing, its structural condition, household fixtures and appliances (or lack thereof) so that their impact on the loan application can later be measured. This can also be a useful indicator of the applicant's permanency of residence in the community.

Tips for Credit Officers when interviewing a potential client:

- Be certain to ask all relevant questions, so as to get a clear picture about why the client needs the loan, how the client will use the loan and how regular payments can be made without unnecessary stress to the business/family.
- Get further impressions of the client's character, trustworthiness and reliability.
- Get a clear picture of the applicant's cashflow and how this will affect his/her ability to repay the loan.
- Review the screening and loan application forms before the site visit and compare them to what you see and hear on site.
- Ensure that the potential client fully understands his/her future loan obligations, especially the incentives for prompt payment and the consequences for paying late.
- Avoid doing business with a client who is not believed to be trustworthy.
- Seek a second opinion from a supervisor if for any reason there is doubt on a particular business-related matter. Character and cashflow assessments however, are the sole responsibility of the Credit Officer.
- Before closing the interview, remind the applicant to visit the MFI during the week to follow up on the status of his/her application. Schedule the applicant's visit after the Credit Committee meeting, when all applications for the week have been reviewed.

If there are no adverse findings, guarantors are interviewed. The guarantor should also complete and sign the guarantor's agreement.

> In some regions, salaried positions are limited and people holding these positions end up guaranteeing for many different clients at many different institutions. It would be prudent for the Credit Officer to ask the guarantor if they are guaranteeing any other loans. Also, the MFI should keep a data base of guarantors to check the level of exposure for one guarantor. Some MFIs can generate a report to this end through their MIS.

In addition, the following references should be interviewed, using the appropriate section of the loan appraisal form presented below, to better understand the business and the applicant's credit habits (this was also listed above):

- At least one supplier - to make sure that the applicant is reliable and pays his/her bills on time
- At least one creditor - to see for how long items are given on credit and verify the outstanding amount owed
- At least one employee - to get that person's description of the business activities and if they are paid on-time
- At least one competitor - to see if s/he is a stiff competitor or if something is wrong
- Landlord (for residence and business) – to determine if they are responsible tenants
- Neighbours - to verify how long they have been in the community and their reputation
- Community and church leaders - to verify character
- Money lenders - to see if there are or have been any outstanding loans
- Banks - to verify accounts, payments, loans, etc
- Market official (if the client is a trader or owner of the market)
- Others related to the business

These people are usually good sources of information regarding the applicant's character and credit habits, his/her reputation in the neighbourhood, and/or whether the applicant is an old or new resident in the community.

Guidelines for interviewing client references. The Credit Officer:

- Gives an assurance that all information provided will be kept strictly confidential.
- Asks for the name of the respondent and if s/he knows the applicant
- Asks him/her where the applicant lives and to confirm if the applicant is a resident.
- Informs the respondent that the client is applying for a loan at the MFI and that the purpose of this conversation is to verify the client's willingness and capability to repay the loan.
- If applicable, asks what s/he knows about the client and her family – how long the client has been residing in the community, who are the members of the client's household, what are the occupations of each of the household members, and what the household members' sources of income are.
- If applicable, inquires how the other neighbours regard the client and her family, whether they are known to be honest, if they are living beyond their means and if they are hardworking.
- For business neighbours, asks about the general condition of business activities in the area.
- Asks about whether sales of most businesses are up or down, and why is this so.
- Asks about how long the applicant has been engaged in her/his present business and whether the applicant's business is similar, in terms of sales, to the other business enterprises.
- Tries to find out who the applicant's suppliers and creditors are, and whether the applicant is in good credit standing with these suppliers or creditors.
- Finally, asks the respondent if the applicant is known to borrow money from others and if so, how reliable the applicant is in repaying borrowed amounts.
- At the end of the interview, thanks the respondent and gives another assurance that all information provided will be treated confidentially.

If the applicant has any outstanding or previous loan(s), the Credit Officer should confirm the current situation by receiving a written advice with information such as: the type of loan, the date the loan was granted, the amount, term and maturity of the loan, outstanding balance, securities offered and the paying performance of the borrower. The information gathered from this form is considered in the loan appraisal form. Sometimes the Credit Officer may not be able to obtain a letter from the other institution, so they should use the loan contract and receipts to confirm repayment.

If there are adverse findings, the Credit Officer should explain to the applicant why his/her application can not be processed further. For example, the applicant may have an outstanding obligation with a supplier or other creditors, poor payment habits, an unfavourable reputation within the community, or may not have sufficient debt repayment capacity.

Q: What is the Loan Appraisal Form?

The Loan Appraisal form is a very detailed guide for the Credit Officer to learn everything about the applicant's business and any household issues that may affect it. This form must be reviewed in great detail before going on the site visit, as it will be easier to collect the information needed to make a good credit decision. When preparing to complete the form, the Credit Officer should remember the three crucial questions:

1. Is there a GOOD FIT between the customer and the company?
2. Will the customer BE ABLE to repay?
3. What are the key RISKS?

The loan appraisal form is a critical component in the decision-making process and it is therefore extremely important for the Credit Officer to get to know this form well. This form describes the proposed loan, motivation to repay, possible risks and if it makes business sense.

The quantity of detail on the form depends on the size of the business, the competition and size of the loan. This is a suggested form that has the merit of being clear, while still being quite exhaustive.

Q: How to complete the Loan Appraisal Form?

Sample MFI Loan Appraisal Form

MFI - INDIVIDUAL LOAN APPRAISAL FORM	Today's Date:__________________
I. PERSONAL INFORMATION	
Name of Applicant:	Date and Place of Birth:
Resident Address:	
Resident since:	Owned/Rented/Other:
Education and working Experience:	
Name of Spouse:	Date of Birth of Spouse:
Spouse's Education and working experience:	

II. LOAN INFORMATION	
Amount applied for:	Period applied for: months
Purpose / Use of loan:	
Proposed instalment of applicant: how much does s/he think he can repay weekly ___________ monthly ___________	

III. HOUSEHOLD INFORMATION			
FULL NAME OF HOUSEHOLD MEMBERS AND DEPENDENTS (Relationship to Proprietor)	CURRENT OCCUPATION/ ECONOMIC ACTIVITY	REGULAR MONTHLY NET INCOME	SCHOOL / BUSINESS/EMPLOYMENT ADDRESS
SIZE OF HOUSEHOLD:		TOTAL:	
OTHER HOUSEHOLD INCOME	SOURCE OF INCOME	AMOUNT	STABILITY
		TOTAL:	
HOUSEHOLD EXPENSES:			
Item	Amount per day/week/month	Documents Supplied	Comments (on-time/delinquent, etc.)
Food			
Water			
Electricity			
Kerosene			
Charcoal			
Education			
Transport			
Rent			
Clothing			

Health			
Telephone			
Instalment (consumption loan)			
Other:			
Other:			

FIXED ASSETS OF HOUSEHOLD:	
Item (detail name, brand, model, year)	Estimated Value (according to collateral evaluation):

Home Visit				
Date of visit				
Name of MFI representatives on visit				
Client present?				
Names and relationship of other family members present				
Living conditions?				
Is the household expenses verifiable based on the living conditions?				
Additional information gathered on home visit from family members and/or observations				

IV. BUSINESS INFORMATION	
Business Activity:	Age of Business:
Name of Business:	Location of Business:
Business Status (licensed):	Vat Registration No.:
Telephone No.:	Business Premises Owned / Rented:

A. MARKET AND MANAGEMENT	
Assessment of Market:	**Assessment of Management:**
Type of clients:	Capacity of Applicant:
Location good or bad (why?)	Relevant experience and training
Competition	Financial skills and records kept well:
Other observations	Other:
B. CUSTOMERS	
Describe the main client base?	Are there threats to your client base?
Any goods given on consignment to customers (accts receivables)?	Age of receivables?
Did the Credit Officer visit this source? O Yes O No	What did they say?

Business Site Visit	
Date of visit	

Name of MFI representatives on visit	
Client present?	
Location - good for business?	
Description of the premises? (size and condition)	
Level of activity / utilization of equipment during your visit?	
Current inventory levels (quantity and amount)? How did you verify this? Storage conditions?	
Business facility owned or rented? Rental contract through loan period?	
Amount of cash on hand? How did you verify this?	
Impression of management during the site visits?	
Employees present? Job titles? Were they productive?	
Customers present? Were they buying? Did employees attend to customers in a professional manner?	
Other Comments:	

C. BUSINESS CASHFLOW INFORMATION

i. BUSINESS SALES

Business Activity	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
High/ Med/Low												

High/Medium/Low seasons established according to: _____ Client's verbal confirmation ______Records

Is this current month which you are making the appraisal a high sales month? O Yes O No
If yes, what percentage should the sales/raw materials should be adjusted on the cashflow (i.e. 80%)?

For Manufacturing / Production Businesses only:

Item	Quantity sold per month	Sales Price	Total Per month
1.			
2.			
3.			
4.			
5.			
Total:			

ii. BUSINESS OPERATIONAL EXPENSES AND RECORDS

a. Cost of Goods Sold for a trade business:

Times purchases are made during the	Month:	Week:
Amount of each purchase:	Minimum:	Maximum
Average per month:		

Amounts established according to: _____ Client's verbal confirmation ______Records

If according to client's verbal confirmation, how was it verified?

b. Cost of Goods Sold (Manufacturing / Production business ONLY):

Item	Quantity sold per month	Cost of Material for one item (use worksheet Cost of Goods Breakdown / Production)	Total cost of good sold per month
Total:			

c. Other Operational Expenses:

Receipts of Bills (e.g.)	Average 3 months receipts (if possible)	Documents Supplied and in file	Comments (on-time/delinquent, etc.)
Water			
Electricity			
Kerosene			
Telephone			
Salaries to employees			
Rent			
Transport			
Food at workplace			
Instalment			
Other:			
Other:			

C. BALANCE SHEET INFORMATION

i. CURRENT LIQUID ASSETS

Name/Address of Institution	Amount	Document Verification?
1. Cash on hand (in register – must physically count and verify)		
2. Current Account, Name of institution:		
3. Savings Account, Name of institution:		
4. Other:		
TOTAL CURRENT ACCOUNT		

ii. BUSINESS FIXED AND MOVEABLE ASSETS

Qty	Description	Appraised Value	How was the appraised value determined?	Age	Condition	Supplier
TOTAL APPRAISED VALUE						

iii. SUPPLIER CREDIT

How do you buy your goods/services (cash, on credit, or consignment)?		**Are there threats to your production/sales/ services? Only one supplier, etc.?**	
Name of Supplier	**Amount per week or month**	**Frequency of Supply**	**Day of Repayment (Due)**

iv. CREDIT – CURRENT AND HISTORICAL

Name/Address of Creditor/Supplier (must have letter from Creditor)	**Original Loan Amount**	**Current Outstanding Loan Amount**	**Term and Due Date**	**Amount of Payment / Frequency**	**Any Delinquencies?**	**Docs Verified?**
1.						
2.						
3.						

TOTAL OUTSTANDING LOAN AMOUNT CURRENTLY (LOANS PAYABLE)		

v. BUSINESS ASSETS		**vi. BUSINESS LIABILITIES AND NETWORTH**	
Cash on hand		Credit from Suppliers	
Current Accounts (must have documented proof)		Loan Payables	
Savings (must have documented proof)		Other Payables	
Debtor (Accts. Receivable) (have documented proof)			
Raw Materials (cost, not sales price) & Goods in Process			
Inventory (Finished Goods) (attach detailed list)		**TOTAL LIABILITIES**	
Fixed and Moveable Assets (from above – should be evaluated using MFI method and forms)		**TOTAL EQUITY** (Total Assets – Total Liabilities)	
TOTAL ASSETS		= **TOTAL LIABILITIES & EQUITY**	
COMMENTS:			

D. REFERENCES – Assessment of willingness to repay				
Name of Reference (neighbour, LC, supplier, employee, others) must have 3	Date Interviewed?	Relationship to Client	How long has the client known this person	Comments of the Referee

E. ACCOUNT OFFICER'S RECOMMENDATION & CONCLUSION					
Loan Amount:			**Loan term:**		
Purpose of the loan:					
Item to be purchased	**Unit**	**Quantity**	**Paid for by Loan**	**Paid for by Client**	**Total Project**
TOTAL:					
Loan Officer's Conclusion (why should the Credit Committee approve this loan?):					

F. COLLATERAL					
How has the CM evaluated the collateral? *Real estate assessor's evaluation* *property with the same sq meters and similar location nearby sold for $___________* *other:*					
Was the Collateral Evaluation Form completed? ___ Yes ____No By whom:					
Item	**Acquisition Cost**	**Acquisition Date**	**Market Value**	**Liquidation %**	**Liquidation Value**
TOTAL LIQUIDATION VALUE					**$**
Total Liquidation Value / Total Loan Value (must be > 150%)					**%**

I, ___________________________, hereby certify that all the information stated in this INDIVIDUAL LOAN APPRAISAL FORM is true and correct and that I shall be held responsible for any misinterpretation. I have verified all the information by more than one source and not only taken what the client has said and written it within.

Name/Signature of Account Officer: _________________________ Date: ____________________
Noted by:___________________________
Supervisor

G. DECISION OF LOAN COMMITTEE			
Approval:		**Decline:**	**Deferred:**
Loan Amount:		**Reason for Decline or Deferral:**	
Loan Term:	Interest rate:		
Instalment:			
Repmt freq: ____Month ____Bi-weekly ____Weekly			
Collateral (same as above or note changes here): Total Amt:			

Name:	Signature:	Date:
Name:	Signature:	Date:
Name:	Signature:	Date:
Name:	Signature:	Date:
Name:	Signature:	Date:

(Ledgerwood, 1999)

Inventory Form

#	Item	Unit	Quantity	Cost per Unit	Total Cost	Sales Price per unit for 10 various items
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						
12						
13						
14						
15						
16						
17						
18						
19						
20						
21						
22						
23						
24						
25						
26						
27						
28						
29						
30						
31						
32						
33						
34						
35						
36						
37						
39						

WORKSHEET FOR CASHFLOW ANALYSIS (000' Ush)

1. **Sales and Purchase**

Day	**Sales**		
	Low	**Average**	**High**
Monday			
Tuesday			
Wednesday			
Thursday			
Friday			
Saturday			
Sunday			
Weekly Total (add Monday – Sunday)			
Monthly Total (weekly *4)			

2. **Retail Store**

Product	**Wholesale Cost** (A)	**Wholesale Quantity** (B)	**Unit / Item Cost** (A/B=C)	**# of Items Sold per week** (D)	**Sale Price** (E)	**Total Cost** (DxC=F)	**Total Sales** DxE=G)	**Sales Multiplier (TotalF/TotalG)**
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
TOTAL								

3. **Sales Multiplier (monthly)**

	AVERAGE	
Average Monthly Sales Total (from #1 above)		This will be the Monthly Sale Income in the c]Cashflow
Sales Multiplier		
Average Total Raw Materials / Purchases for one month (Monthly sales * sales multiplier)		This figure will be the Monthly Cost of Raw Materials in the Cashflow

Credit Officer observations:

COST OF GOODS SOLD BREAKDOWN (Manufacturing or Production)			
Item #1		**Item #2**	
Raw Material 1		Raw Material 1	
Raw Material 2		Raw Material 2	
Raw Material 3		Raw Material 3	
Raw Material 4		Raw Material 4	
Labour Cost per Item		Labour Cost per Item	
Transport		Transport	
Other		Other	
Total COGS per Item		**Total COGS per Item**	

Item #3		**Item #4**	
Raw Material 1		Raw Material 1	
Raw Material 2		Raw Material 2	
Raw Material 3		Raw Material 3	
Raw Material 4		Raw Material 4	
Labour Cost per Item		Labour Cost per Item	
Transport		Transport	
Other		Other	
Total COGS per Item		**Total COGS per Item**	

Individual Lending Appraisal Form - Descriptions

<u>Page 1 of the Individual Loan Appraisal Form:</u>

III. HOUSEHOLD INFORMATION

Household Members and Dependents: Names of all family members, as well as relatives and other household members, who are dependent on the applicant and his/her spouse. Include the applicant in the list.

Current Occupation/Economic Activity: Note whether each household member is a student, currently working as an employee, laborer, entrepreneur, or unemployed. If the applicant is employed, apart from running his/her own business, supply the address of the workplace.

Regular Monthly Net Income: This is a fixed amount of monthly net income from each household member, such as salaries, pension, monthly overseas remittances, and/or any other income that is fixed on a monthly basis.

School/Business/Employment Address: If a household member is working, indicate the address of employment. If he/she has a business, indicate the business address, and if a student, write the school address, including year, level and section.

Size of Household: How many persons, family members and non-family members, live with the applicant in his/her residence.

Total Monthly Household Net Income: Total of all the regular monthly net income of each working household member.

Other Household Income: This refers to sporadic and seasonal activity. The applicant is asked to provide the source of income, the amount and how often this source is generated. It is added to more regular sources of income to give a more accurate total of the household income.

HOUSEHOLD EXPENSES

The Credit Officer should know the approximate monthly expenses of different size families. It is important to make sure that that at least the minimum total expenses are being recorded and that clients are not cutting corners on expenses in order to receive larger loans.

Food: Refers to the amount spent on purchasing food items. This row should list daily, weekly, and monthly purchases. Multiply daily food purchases by 28 days.

Water/electricity/kerosene/charcoal: Refers to the amount paid from the household income for utilities services, such as light, water, and telephone. This is generally a monthly expense. They are separated out in the Individual Loan Appraisal Form.

Education: Refers to the amount paid for schooling during the month, including school fees, uniforms and other school clothing, books, other fees, and transportation. Note that some school fees are paid monthly or four times per school year. In either case, use the total amount paid per year for all school fees and school clothing and divide by 12 to arrive at the average amount paid per month for these items. Multiply by 28 days the daily costs of the students' daily meal allowance and/or transportation and add this figure to the monthly education expense.

Transport: Refers to the amount paid for transportation for family members (excluding children attending school) during the month (e.g. fuel, taxi fare, etc.). This is generally a daily expense item.

Housing/Rent: Refers to the amount paid per month for rent or housing amortization, where the applicant resides. This is generally a monthly expense.

Clothing: Refers to the amount paid for clothes in the household and is generally a monthly expense.

Health: Refers to the amount allocated for visits to the doctor or dentist, surgery, medicine purchases, health care premiums, among others.

Telephone: Refers to the charges for a fixed line or cellular line. Note that in many cases, this may not be relevant.

Installment (consumption loan): Refers to consumption loan payments that are made daily, weekly and/or monthly by the household.

Other (Household) Expenses: Refers to additional household expenses paid, but not included in the above categories. They include home repairs, recreation (parties, celebrations, and weddings), household emergencies and insurance (life and accidental).

Documents Supplied: Refers to bills showing the actual costs incurred. Comments (on-time, delinquent, etc.) in the last column of the table indicate whether or not the household pays these expenses on time, or not.

FIXED ASSETS OF HOUSEHOLD: The same information as in the loan application form.

<u>Page 2 of the form:</u>

IV. BUSINESS INFORMATION:

In this section, the Credit Officer should collect some basic information about the applicant's business. This includes market factors, namely clients, supplies, and production/sales. Descriptions and potential problems/risks for each market factor are explained.

General information:
Business premises owned/rented: does the applicant own, rent, or share the business and/or residential premises? Is the business home-based or ambulant?

A. MARKET AND MANAGEMENT

The market and management section refers to two of the 3Ms in the credit analysis - market and management.

Assessment of Market (4 factors):

Type of clients: neighbors, farmers, students, employees, businesses, etc.

Location, good or bad and why?: this indicates where the applicant sells his/her good/services and whether or not this is good for the business. Is the business owner in close proximity to customers and suppliers?

Competition: indicates the type of competition and the competitors' names.

Other observations: any other new trend or factor that may affect the business.

Assessment of Management: This section refers to the capacity of the Manager to run his/her business in terms of knowledge of the market, skills and experience. This is a summary of the management information obtained from the various interviews with the applicant and references. Trainer refers to questions asked in Exercise 4.1.

B. CUSTOMERS

Main client base: More information about type of clients as per above section. Are there any threats to the client base? Indicate in this section if there is any likelihood that these could be affected in any way. Examples of possible threats are: new competition for the trade or business, within or outside the community, with whom applicant will now have to compete; the likelihood of not being able to obtain goods on a regular or timely basis; power-outages, labor problems; staff changes, etc; that may affect production, sales and services.

Any goods given on consignment to customers: some customers, such as public market vendors may obtain their goods on consignment or instalment.

Age of receivables: indicated the age of the debt owed to the applicant by customers and to be taken into consideration in cashflow considerations.

Also describe whether there is a concentration of customers; for example, if one or two customers make up a large percentage of sales. In general, the more concentrated sales are to a small group of clients, the riskier the client.

C. BUSINESS CASHFLOW INFORMATION

The cashflow section is designed to help the Account Officer prepare and analyze the daily, weekly, and monthly income and expenses of the applicant and determine the appropriate amount of loan that can be reasonably paid out of the cash generated by the household and the business. It also allows the account officer to define the specific terms of repayment that are suited to the applicant's repayment capacity.

i. BUSINESS SALES

Business activity per month with high, medium and low session: records the trends in sales for each business activity for every month of the year, indicating the high, average and low seasons of the business in terms of sales. Enter H, A or L as appropriate in the relevant columns of the appropriate months. Credit officer checks information with the source, establishing that for this sector of activity, such months are high, medium or low and double checks with clients and with records confirming the financial results. The appraisal form also asks by which percentage the sales are adjusted in the cashflow in case the month of enquiry is a high sales month.

For Manufacturing/production businesses only: this refers to businesses such as eatery, furniture-making, food processing, beauty parlor, welding, transport, etc. This table indicates for each item sold, the quantity sold per month, at which price to arrive to the total USH per month, per item. This is to be contrasted with the business expenses described below.

Also, analyse average transaction size. Clients that have sales made up of a small amount of large transactions are generally more risky than clients that have a large number of small sales.

ii. BUSINESS OPERATIONAL EXPENSES AND RECORDS

a. Cost of goods sold for a trade business

The income and expense section of the form will require a separate worksheet to determine the income of the business and its raw materials expense for 3 timeframes – daily, weekly, and monthly. Trainer refers to a later training session specifically on cashflow analysis. Here the class will only go through the forms to ensure they are clear.

If the Credit Officer is knowledgeable about the business, there may be no need for separate worksheets and the information can be collected directly on to page 2 of the Loan Appraisal Form. If the Credit Officer needs a step-by-step process to calculate the costs of goods sold per week and month, then refer to the worksheets. There are two separate cashflow worksheets: one for retail businesses on page 7 (retail store, buy and sell, etc.) and the other for manufacturing and personal services on page 8 (eatery, furniture-making, food processing, beauty parlor, welding, transport, etc.).

(Refers to worksheet for cashflow analysis, page 7 for retail stores).

<u>Worksheet #1: Sales and Purchases</u>

To know the estimated daily, weekly, and monthly sales of the applicant, the Credit Officer may ask the following questions as a starting point:

How many days in a week are you open for business? This question will help the Credit Officer later in the cashflow analysis in determining the applicant's daily and weekly sales.

What are your highest sales on a good business day? How many days in a week do you earn this amount? Can you tell me what days are these? Enter response in Worksheet 1.

What about on a slow business day, what are your lowest sales? How many days in a week do you earn this amount? Can you tell me what days are these?

And what about on an average business day, what are your average sales? How many days in a week do you earn this amount? What days are these?

Now that the Credit Officer has the respondent's estimate of high, average, and low daily sales, the next step is to make an assumption about his/her daily sales for the week. To estimate these amounts, it is important to take into consideration the days that the respondent mentioned as high, average, or low days.

The Credit Officer adds the daily sales to get the weekly sales and multiplies this by four weeks to get the monthly sales. See example below.

Worksheet 1. Sales and Purchases

DAY		Note mean daily sales here:
	Daily Sales	
Monday	80	Mean daily sales
Tuesday	60	80 * (1/6) = 13.33
Wednesday	60	60 * (5/6) = 50.0
Thursday	60	13.33 +50.0 =63.33
Friday	60	
Saturday	60	
Sunday	0	
Weekly Sales (A)	380	
To get monthly income: Multiply (A) by 4 weeks (Ax 4)	1,520	

Proceed to worksheet #2.

Worksheet #2: Sales Multiplier

In the case of buy and sell activities, such as retailing or wholesaling, instead of using expenses for purchases made during a week (or month), some of which end up as inventory, questions should focus on the cost of goods sold.

The following steps will determine the sales multiplier:

Ask the respondent to name between 5-6 main products that represent the majority of his/her sales. You may ask: What are the most common items that you sell every day? (Write these down in the **Product** column).
For each of the products, list in the appropriate columns, the required information.
After repeating this process for each of the 5-6 main products sold, divide the total sum of all the item costs by the total sum of their sale prices. This figure will give you a sales multiplier that can be multiplied to the estimated daily, weekly, and/or monthly sales figure, depending on the timing of the procurement of goods, to arrive at the estimated cost of goods sold.

	QUESTIONS TO ASK:
Wholesale cost of the product; (A)	GO THROUGH EACH QUESTION FOR EACH OF THE 5 OR 6 ITEMS: Can you tell me how you buy ______ for your shop? By wholesale or retail? How much did it cost you?
Quantity per wholesale purchase (e.g. 50 kilos, 1 dozen, 25 pieces) (B)	In what quantity? By the dozen? Sack? Pieces?
Item cost or the unit cost of the product (wholesale cost/quantity: (A/B=C) e.g. 12,000/24 = 500	
# of items sold per week (D)	

Sale price per unit (E)	What is your selling price for this item?
Total cost (DxC=F)	
Total sales (D x E =G)	
Sales multiplier (F/G)	

Worksheet #3: Sales Multiplier (monthly)

a. Using the sales multiplier to arrive at estimated cost of goods sold

Use the sales multiplier to determine the estimated cost of goods sold (purchased) by multiplying the sales figure, depending on the timing of goods procurement, by the sales multiplier. This will give you the estimated cost of goods sold (purchased) for a monthly timeframe.

b. Cost of goods sold (manufacturing and production only)

The form on page 2 will be filled out using the worksheets on page 8. Worksheet 8 assumes that information is available by month. It is disaggregated by item, and for each item, by the raw material, labour and transport costs required. This provides the cost of goods sold per one unit of one item. Then, Table b on page 2 can be filled in by multiplying by the quality sold per month (taken from the above table for manufacturing only).

Page 3 of the Loan Appraisal Form:

c. Other Operational Expenses:

Receipts of Bills: Includes water, electricity, installment purchase, housing amortization or house rent, etc. Note the name/business name and address of each.

Documents Supplied: Indicate what documents were supplied by the applicant to examine payment records, e.g., 3 monthly receipts on utilities, payment receipts for house rental, payment receipts from suppliers/creditors, etc.

Average 3-month Receipts: Total the bills/payments for each month and get the average for utility bills. These figures will be later entered into the cashflow form.

Comments: Does the applicant have a good payment record? Indicate whether payments were made on time, erratic, or overdue, or if applicant has any outstanding payment balance.

C. BALANCE SHEET INFORMATION

Review of assets is conducted as a means of counterchecking the applicant's declaration of income against the actual assets s/he has acquired. For example, if the applicant exaggerates information regarding his/her sales and income, but has no evidence of household or business properties, this may have an impact on the loan application. It is also a means of looking at a client's potential for bigger loans that will require some form of security or collateral in the future. The Credit Officer must always endeavour to inspect, check, and appraise the assets of applicants, especially when these assets are offered as collateral or security. This will be discussed in greater length in a session on collateral.

i. CURRENT LIQUID ASSETS

These assets are in cash or in a bank account and should be noted with the amounts and names of the various institutions. Indicate whether or not documents verify the amount stated by the applicant. In the savings section, determine how much cash the applicant has available for personal and/or business use. Sources of savings may include other MFIs, commercial banks, cooperatives, credit unions and informal savings groups.

ii. BUSINESS FIXED AND MOVEABLE ASSETS

Quantity: refers to the number of each asset owned by the applicant.

Description: refers to all business and household assets, including fixed and movable assets, such as business equipment, vehicle, appliances, etc.

Appraised Value: is the present market value of the assets mentioned.

How was appraised value determined: What are the means of appraisal**?**

Age: number of years since the asset has been bought.

Condition: the present condition (good/fair/poor) of the assets mentioned.

Supplier: name and location.

iii. SUPPLIER CREDIT

This table refers to how goods are purchased from suppliers and reviews the amount paid per time period, per supplier, the issues faced (such as dependency on one supplier) and day of repayment, in case some amount is still owed on any of these assets.

iv. CREDIT – CURRENT AND HISTORICAL

This table provides updated information regarding potential loans that the applicant may have with some of his/her suppliers. It establishes the applicant's ability and discipline in making regular and consistent loan payments, including loans from suppliers and other non-bank creditors. The Credit Officer must verify credit references by contacting persons with whom the applicant had any previous relationship that required the making of regular payments.

Name and Address of Creditor/Supplier: name and address of bank, supplier, and other creditor from whom loan and/or credit purchase was last received. This includes monetary loans from banks and other creditors or purchase loans from suppliers.

Original Loan Amount: the amount of loan agreed upon with supplier.

Outstanding Loan Amount: the amount of present loan still owed at the time of the loan application to the MFI.

Term and Due Date: the maturity of the outstanding loan.

Amount of Payment/Frequency: the amount of payment due each time and if payment is scheduled daily, weekly, or monthly.

Any delinquencies: the amount of late payments on the loan, if any.

Docs verified? Check whether or not loan documents verify information provided verbally by the applicant during the visits, and from the screening and application forms.

Total Loans Outstanding: the sum of all outstanding loan amounts at the time of the review of the application.

v. BUSINESS ASSETS

Cash on hand: as per above.

Current accounts: as explained above.

Savings: as per above.

Debtor (Accounts Receivable): amounts owed to the business by customers, but not yet collected.

Raw Materials and goods in process: value of material not yet in production. Quoted as the cost of goods, not sales price. These include such things as wood for furniture-making, cloth and supplies for dressmaking, and cement, gravel or sand for block making. If involved in merchandise and sales, the value of all goods in stock should be quoted. Goods in process include unfinished products, such as furniture or dresses, etc. This is the value of raw material at cost, plus labor and transport to date (i.e. 50% complete).

Inventory (Finished Goods): the value of goods ready to be sold at cost of goods; not the sales price. This also includes stock in a vendor's stall. This is raw material valued at cost, plus labor and transport.

Fixed and moveable assets: see above.

Total Business Assets: the sum of the applicant's cash at the bank, accounts receivables, raw materials, goods in process, finished goods, fixed and moveable assets.

vi. BUSINESS LIABILITIES AND NET WORTH

Credit from suppliers: amounts due to suppliers.

Loan Payables: amount owed by the applicant in relation to the business. These include short-term or long-term loans.

Other Payables: any other amount owed by the applicant and other liabilities such as taxes, insurance/health premiums, small lay-away items, etc.

Total Business Liabilities: the total of all monies owed by the applicant, due to the business.

Total equity: equity and accumulated profits generated by the applicant. This is the difference between Total Assets and Total Liabilities.

Total Business Liabilities and Equity: should always be equal to the total business assets.

D. REFERENCES – Assessment and willingness to repay

In this section, the Credit Officer will summarize the results of the character/credit investigation into the applicant through interviews with 2 to 3 individuals who know the applicant's character and credit history. The trainer refers to the earlier section of this session that explained reference checks and interviewing (*Exercise 4.5* and slide 8). The table in the loan appraisal format is self-explanatory.

E. CREDIT OFFICER'S RECOMMENDATION AND CONCLUSION

In this section, the Credit Officer will include the loan amount and term recommended, based on the results of his/her credit investigation, cashflow analysis, and debt repayment capacity analysis. The trainer mentions that later sections of this training exercise will focus on reviewing how to determine the repayment capacity and cashflow analysis. The project purpose will also indicate the owner's contribution. The Credit Officer should indicate in this section any important observation which may have an impact on the credit approval.

COLLATERAL

This section will be further described in the session on collateral. The loan appraisal form summarizes information for each item regarding acquisition cost, date, market value and liquidation value. It also provides information about who evaluated the collateral.

CERTIFICATION

The Account Officer must certify that s/he has correctly completed the form, based on a thoroughly conducted credit investigation and cashflow analysis. After a careful review, the supervisor notes his/her approval by signing at the bottom-left section of the form. If there are mistakes and missing information that need verification, the supervisor must not sign and endorse the application to the Credit Committee.

Name/Signature of Account Officer: notes the Account Officer in charge of the applicant's loan application process.

Date: date of completion of the investigation process.

Noted by: signature of the supervisor if the credit analysis is properly completed.

Loan Officers will notice by now, that some of the basic information on the Loan Appraisal Form will be the same as on the screening and application forms. This can simply be filled in from those forms.

Summarized below, is the information for each of the following categories and some of the questions that the Loan Officer can ask to help get the information s/he needs:

<u>Household information & expenses:</u> the Credit Officer probes into the personal life of the applicant, explaining that the information is needed to gain a better view of the overall situation of the applicant. The goal is to ascertain who the members of the household are and what their relationship and dependency is on the applicant. It is important to get as much information here as possible, including (if there are any): additional incomes, students in the family, and family members involved in other businesses? Do "extended" members of the family spend significant time there? What do they spend money on? The Credit Officer will start to get a rough idea of how much household spending should amount to. S/he should be on the lookout for anything extravagant or out of the ordinary.

Possible leading questions: Does your spouse work in the business with you? Does your Grandmother or an older sibling look after the children? If the children are in school, inquire which school they go to (it is easy to find out fees if the Credit Officer does not feel comfortable asking directly).

Business Information: In this section, the goal is to gather as much applicable information about the business, the market and competition, as possible. Names of clients, suppliers and competitors are essential for learning about the business. A full history should be obtained, including when operations began, the credit history of the applicant, his/her qualifications and experience in running this business and general information about who owns what percentage, if the premises are owned or rented, and what are the costs involved. These questions are quite standard and easily documented. The Credit Officer explains to the applicant that this information is needed as a basis for understanding the market and how well the business fits into its surroundings.

Market & Management: This section, covers two of the three M's **-** market and management. The Credit Officer should ask who the customers/clients are and how the applicant is viewed in the area. The Credit Officer should decide and comment on whether the location is good or bad, and why. Is it physically in the wrong place, or is it run-down? Is there competition nearby?

The Credit Officer needs to assess the character of the manager. Does s/he appear to have the right experience, training and skills? Is this person dedicated to the business? Is this the right business owner for the business? Is he/she a good fit? Is the borrower reliable? Honest? Hardworking?

Financial Analysis: This section is dedicated to gathering numbers and figures, anything that will help put together a cashflow in order to analyze the income against the expenses, with the goal in mind of determining if the applicant can repay the loan. It helps determine the specific loan terms as well. The Credit Officer will check information to calculate monthly business activity, going back as many months as possible. This allows for a better picture of the business on an annual basis, taking into account seasonality and trends.

Similar to the household information, a laundry list of costs should be detailed on a monthly basis, again recognizing daily or weekly highs and lows. The Credit Officer should figure out an average if sales and expenses seem to be sporadic.

Different industries need different attention to detail. There are differences between the information needed for a retailer's loan versus a manufacturer's, or a production based loan.

Credit history, including prior loans, is documented, as well as supplier credit. Loan applicants should be encouraged to give all information about bank loans, as well as credit taken from neighbours and friends. Other important notes on suppliers are the time period in which they are paid, and the terms they are expected to meet. Notes should be taken in relation to how many suppliers the applicant uses. It is important if they are dependent on just one or two suppliers AND there are not others available.

References: The purpose of this section is to find three persons who will serve as references for the applicant. The Credit Officer is looking for information on the character of the applicant through interviewing at least 3 individuals who know the applicant's character and his/her credit history.

Collateral: This section will be further described in the Collateral session of the training. The loan appraisal form summarizes information for each item regarding acquisition cost, date, market value and liquidation value. It also provides information about who evaluated the collateral.

Credit Officer's Recommendation and Conclusion: The Credit Officer waits to complete this section until they complete the cashflow form, ratios and loan structuring. After this, s/he should have a good idea of whether or not the applicant will be a good client. Then, the Credit Officer makes his/her recommendation, including the loan amount and terms, if they believe it should be approved.

It is very important that the Credit Officer indicate with a "red flag" any important observations which may influence the credit approval. This also includes any risks that may affect the client. The Credit Officer should never conceal any information from his/her

Manager or the Credit Committee. The Credit Officer should reveal the information along with his/her mitigating factors and let the Credit Committee make an educated decision on the risk.

Certification: Finally, the Credit Officer must certify that s/he has correctly completed the form, based on a thoroughly conducted credit investigation and cashflow analysis. After a careful review, the supervisor notes his/her approval by signing at the left-bottom section of the form. If there are mistakes and missing information that need verification, the supervisor must not sign and endorse the application to the Credit Committee.

The Credit Officers should have a thorough understanding of the steps PRIOR to the entire process. This way, they will know exactly what they are looking for and what comes next. This starts as early as the screening form, but is particularly relevant in the way the application form will be filled in and the site visit will be conducted. In most cases the information from the client will come in random order, so the Credit Officer must know the form well and allow the conversation to flow. At the end of the site visit, the Credit Officer may need to go back and fill in the gaps.

If the Credit Officer does not understand and know the forms thoroughly, s/he will take extra time in figuring them out during the site visit and may need to contact the client later to fill in missing questions, The client will view this as unprofessional and waste of his/her time.

Q: How are the inventory information and figures collected and verified?

First, the Credit Officer should ask the client if they have a list of inventory and the cost of each item. If the client has a list, the Credit Officer should verify the list. There are a couple ways to do this:

Go Manually count the items on the shelf and in the store room. Verify these quantities with the list. Obtain the cost of each item by asking the client and then verifying some of the items at the market. Then, multiply the verified quantity with the verified cost for each item and sum the item sub-totals to get the total inventory.

Select 20% of the items to verify. Choose various items from different sections of a shop to get a random selection of perishable and non-perishable items. Make sure any items that are expired are not included in the inventory. Go through, item by item, manually counting the items on the shelf and in the store room. Verify these quantities with the list. If more than 5% of the quantities on the list do not reconcile with the manual count, then go to option 1. If at least 95% of the quantities on the list reconcile with the manual list, obtain the cost of every item on the list by asking the client and then verifying 20% of the items at the market. Next, multiply the verified quantity by the verified cost for each item to get the item sub-totals. Sum the item sub-totals to get the Total Inventory amount.

The first option is more thorough and complete. The second option should be used in the case of a business with a large quantity of various items, as it would take the Credit Officer much too long to verify every single item.

If the client does not have an inventory list or it is outdated (more than a few days old for a trade business is too old), the Credit Officer must manually create their own inventory list. Follow option one and create your own list.

The inventory list should be placed in the client's file and the Total Inventory amount will be inserted into the balance sheet (this will be covered in **Session 6**).

Remember: Inventory amounts must be listed as cost, NOT sales price. Otherwise, the inventory amount will be overstated on the balance sheet as well as increase the inventory turnover ratio.

Q: When should a surprise site visit (2nd site visit) take place and why?

Before the Credit Committee, the Credit Officer may opt to conduct a surprise visit to the applicant's business, especially in the instance of larger loans (suggested for loans above US $3,000). This is important because a surprise visit is much more likely to reveal a typical day in the business. An applicant who really wants a loan will make sure everything looks beautiful when you come for the first site visit. Be sure to compare both visits!

What specifically should the Credit Officer look for on the surprise site visit?

The Credit Officer should check that the Manager is present, work premises are neatly kept and as on the earlier visit, the inventory looks to be in order, equipment is on-site and in working order, financial books are organised (sales over past few days, if they have them at all, are recorded), customers are present and employees present.

Q: How are repeat loans handled?

Some MFIs have a "next" or "repeat" loan system, whereby access to future loans is guaranteed if previous loans have been paid on time. The system is also usually based on a "graduation" scale, whereby the borrower can secure a larger loan than the previous. Organizations may offer special terms for repeat clients. The table below offers some ideas:

Example of an MFI's Individual Repeat Loan Policy:

	Repeat Loan Terms
Loan size	Maximum 20% increase in loan size
Eligibility requirements	Must have 90% on-time repayments on first loan
Loan terms	Up to 3 months longer for next loan
Loan purpose	Working capital finance or fixed asset acquisition
Interest rate	2% pa decrease for 2nd loan 4% pa decrease for 3rd and subsequent loans
Loan Processing Fee	1 % of loan amount plus VAT (if applicable) No fee for 3rd loan and after
Payment Scheme	Equal monthly instalments
Documents required	Updated application form (client completes), loan appraisal and cashflow (Credit Officer completes)
Collateral/Security requirement	Same requirements as initial loan
Guarantors	2 Guarantors, one of which must not be related to borrower

Q: Why are repeat loans important to a financial institution?

Repeat loans are very important because:

- If you serve clients well when they are small, you will retain them as customers as they grow.
- The processes should be more efficient for a second loan.
- The Credit Officer already has a relationship with client and knows the business.
- The client is obviously satisfied with the organization or would not return for another loan.

The Credit Officer still needs to conduct the due diligence because situations change quickly with micro and small businesses. Also, as loans get larger, the risk to the MFI also increases.

MFIs must consider repeat clients as extremely important to their business. The MFI aims to build a long-term trusting relationship with its clients and give them the best service and products that it can. It wants clients to recommend it to other potential clients and spread the good word. An MFI's clients are its best marketing tool.

Association of Cambodian Local Economic Development Agencies has a good mix of loan products and financial services needed by its customers and delivered through high quality and timely service. The bank has a high number of repeat customers, indicating that customers are generally satisfied. This has been the result of a conscious and deliberate effort to be ***"customer service oriented at all times."*** The bank continuously develops financial products or services that are attuned to the customers' business and financing requirements.

(ShoreCap Exchange SME Training, Manila, 2005.)

Once a Credit Officer secures a good client, they want to keep them because it will take the Credit Officer less time (and less money for the MFI) to analyse repeat loans. Thus, with repeat clients, Credit Officers can maintain and build their portfolio more quickly with lower risk (usually) and contribute to the MFI becoming more profitable.

Marketing experts have long demonstrated that it costs five times more to get a new customer than to keep an old one.

Additionally, the MFI expects the client to appreciate its services and take its repayment obligation seriously. The MFI should have a "Zero" tolerance policy for late payments. All the clients should understand this and the benefits associated with good repayment behaviour. For good repayment performance, clients should be rewarded with better terms and quicker approval than a first-time client.

Contented customers are willing to refer others clients to the MFI. If customers are treated well, it increases their desire to be a good customer. This means higher repayment rates and more deposits.

Conversely, clients that have not been treated well are likely to tell their friends and business associates about the poor service they received. Further, they are more likely to tell their peers about a bad experience than a good experience.

Example of Eligibility Requirements for Repeat Loans

To be eligible for a repeat loan, the borrower must meet the following requirements:

- At least 90% of all installment payments on the previous loan were paid on time.
- Otherwise, the account officer must provide justification for recommending the repeat loan.
- If the loan size increases, the business should demonstrate growth and sufficient capacity to handle the larger loans.
- Subsequent loans can be up to 20% greater than the previous loan and must be justified by the cashflow.

(Ledgerwood, 2001)

Q: What are the steps for processing repeat loans?

The steps for processing repeat loans are:

STEP 1: The Credit Officer ascertains from the client on the last monitoring visit, whether or not s/he is interested in another loan. The main purpose of this last monitoring visit is to make sure the client fully repays the loan and to initiate a follow-up loan. If so, the client is given a loan application identical to the initial application, where the Credit Officer writes "**REPEAT**" boldly on the top of the form. The Credit Officer should take a copy of the original application with him/her to the visit, as much of the information will be repeated. The client should fill out this form immediately to avoid processing delays. The Credit Officer should let the client know that although a larger loan is possible, it still depends on the results of the repeat credit application, his/her repayment record, and his/her cashflow.

STEP 2: The Credit Officer reviews the client's repayment documentation to determine if at least 90% of payments from the previous loan were made on time. The Credit Officer documents the findings.

STEP 3: If the client's repayment rate meets the required level (some MFIs set a repayment rate of 90% or 95% for clients in order to get a subsequent loan), the Credit Officer makes a site visit to conduct a repeat Loan Appraisal and enters the information in the Loan Appraisal Form, again writing in bold "**REPEAT**" on the form to make processing more efficient. The Credit Officer should also write "**NO CHANGE**" on the sections of the forms if indeed there are no changes.

STEP 4: The Credit Officer calls or visits the previous guarantor(s) to ascertain if s/he is still willing to guarantee the client's next loan. The guarantor(s) should then complete the guarantor's profile form, stating that s/he is a repeat guarantor. This should be noted as "**NO CHANGE**" on the form, as well. If the client has a new guarantor, s/he should be interviewed using the same set of questions for guarantors in the initial process.

STEP 5: The Credit Officer checks to see if the client has or had loans with other banks or lending institutions. The Credit Officer then reviews the collateral for any changes in value, location, and/or ownership.

STEP 6: The Credit Officer completes the cashflow and loan structuring for the new loan, making sure that these are sufficient to cover the new loan instalments.

If the client's cashflow is not adequate to cover the new loan instalments, the Credit Officer should make the recommendation that the instalments are not within the client's repayment capacity, keep the amount the same as the previous loan or less if the analysis warrants a decrease in the loan size.

STEP 8: The Credit Officer summarizes the results in the Loan Appraisal and Repeat Loan Evaluation Forms. If justified, s/he recommends improved terms in the case of a very good loan performer.

STEP 9: The Credit Officer files the completed repeat loan documents into the client's credit folder, including:

- Loan Application Form (Noting that it is "REPEAT" and "NO CHANGES", if applicable)
- Loan Appraisal Form (Noting that it is "REPEAT" and "NO CHANGES", if applicable)
- Loan Recommendation Sheet
- Updated cashflow
- Repeat Loan Evaluation Form
- Any information that has changed from last loan (change of address, collateral, etc.)

STEP 10: The process then continues as normal with the supervisor reviewing the client's credit folder thoroughly and checking if the Credit Officer properly completed the loan appraisal and cashflow analysis, etc. The supervisor should be certain that the conditions for the organization were followed, including these suggestions:

If the loan is larger, the proposed increase in the loan amount must follow the organizations limits, including the loan amount and term. The loan term and amount should be regulated by the MFI's policies (e.g. term should not be more than 3 months of the last term and the size of the loan should not be more than 120% of the previous loan).

STEP 11: If the supervisor approves, the loan is sent to the Credit Committee for review and approval. Normal disbursement and filing procedures follow in the case of approval.

Infatuation …

In some cases Credit Officers and Managers become lethargic in analysing and monitoring repeat borrowers, due to their good relationship, good repayment rates and trust in the client. This behaviour can back-fire as the credit analysis does not pick up on typical warning signals. The loan can become a problem without the Credit Officer ever realizing what happened until it is too late. Credit Officers should never let their guard down.

Loan officers must clarify if the client has previously been given a loan, on the new loan documentation. The table below, Repeat Loan Evaluation, can be used as a guide for the Credit Officer and Credit Committee to compare repeat loans.

Repeat Loan Evaluation/Comparison

Name of Applicant___________________________________

Type of Business____________________________________

Loan Information	Loan 1	Loan 2	Loan 3	Loan 4	Loan 5
Date (dd/mm/yyyy)					
Total Amount Disbursed					
Instalment per (month, week)					
Term (months)					
Instalments delinquent & # of days					
Credit Officer's Name					
Assets					
1. Cash and Bank Account Balances					
2. Accounts receivable					
3. Inventory (business)					
4. Fixed assets (business)					
5. Total Business Assets, sum(1 to 4)					
Liabilities					
6. Business debt					
7. Household Debt					
8. Equity (business)					

9. Total Liabilities and Equity (business ONLY)					

Cashflow Monthly					
10. Sales					
11. Business Expenses					
12. Net Business Income					
13. Household Income					
14. Household Expenses					
15. Net Household Income					
16. Total Net Income (Business + Household)					
17. Adjusted Repayment Capacity (50%)					
18. Amount of loan instalment					
19. Disposable Income after loan instalment (16-17)					
Ratios					
Inventory Turnover					
Working Capital					

Red Flags:

- Forms in themselves, will not guarantee success in credit analysis unless Credit Officers are very clear about how to ask questions. Try to find out when potential applicants are not being genuine with you or do not know the information.
- Credit Officers should prepare all the forms well in advance to make sure they do not get overwhelmed by all the information.
- Site visits and reference checks are very important in verifying the information given by the client and gathered by the Credit Officer.

Session 5: Cashflow Analysis

Q: What is a cashflow statement?

The cashflow statement is a tool, which shows the cash coming into and flowing out of a business during a given period of time, a day, week, month or year. It helps to answer one of the key questions: Will the borrower be able to repay?

Think of the cashflow statement like your pocket. If nothing goes in or comes out, then it does not get recorded on the cashflow.

Simple Cashflow Formula:

+ Total Business Income
- Total Business Expenses
= ***Net Business Income (Business Income - Expenses)***
+ Total Household Income
- Total Household Expenses
= ***Net Household Income (HH Income - Expenses)***
= ***TOTAL NET INCOME***   ***(Net Business Income + Net HH Income)***

Step 1: The cashflow starts with *Total Business Income* and subtracts *Total Business Expenses* to get *Net Business Income* (in cash).

Step 2: *Household Cash Expenses* are subtracted from *Household Cash Income*, to determine *Net Household Income* (in cash).

Step 3: *Net Business Income* is added to *Net Household Income* to find *Total Net Income*.

All of the detailed income and expenses must be organised into the daily, weekly or monthly columns. This is according to how the income and expenses are received and paid (e.g. rent is usually paid monthly and therefore would be listed in the monthly column).

Q: Why is the cashflow the most important tool for analysing the repayment capacity of the client?

The cashflow allows the Credit Officer to determine how much cash will be left after all inflows and outflows of cash have been made. This leftover cash, or total net income, is used to determine the repayment capacity. Knowing how much cash will flow into a business is critical to projecting if the business can actually afford to replenish stock and make a loan payment, whether there are sufficient funds to make additional investments or whether they can cover all of their operating costs.

Why do many businesses fail?

Not because they are unprofitable. Not because they do not have adequate equity. Not because they don't have enough collateral.

… But because they are not able to meet their obligations. They don't have enough **cash.**

The Total Net Income is multiplied by the Adjusted Repayment Capacity, which ranges between 25% and 75%, depending on the organization and environment. This adjusted Repayment Capacity is basically the maximum amount that the client can afford to pay per period (daily, weekly or monthly), towards a loan payment. This Adjusted Repayment Capacity, multiplied by the number of payments, will give the total maximum loan plus interest amount. **Note that this is not necessarily the amount that the client will receive. The loan amount depends on the institution's policy, the client's project needs, and structuring of the loan.**

Q: Why are the household income and expenses shown on the cashflow statement?

These are very important to determine the true repayment capacity of each borrower. For smaller businesses, the business and household funds are usually not separated, so the household income and expenses have a direct impact on the business' ability to repay the loan. Each borrower has specific household income and expenses, which definitely affect the total net income over the period. The Credit Officer should also check this income and expenses to make sure they are true. If they are not, it could alter the real capacity of the borrower.

The MFI should set (or at the very least the Credit Officer should know) the minimum family expenses for particular family sizes. If the client records less than this minimum, the Credit Officer should err on the conservative side and insert this minimum amount.

Q: What transactions would not show on a cashflow statement?

Accounts receivable, accounts payable and depreciation are not shown on a cashflow statement.

Q: When would accounts receivable, accounts payable and depreciation appear on the cashflow statement?

Accounts receivable and accounts payable would appear when cash for these transactions is exchanged. Depreciation would never be on a cashflow statement.

Q: Why is a complete financial analysis not done?

For smaller loans, a complete financial analysis is not necessary and may be literally impossible, due to the lack of financial records. Additionally, the cost of lending would increase dramatically, outweighing the income from lending. The MFI must always weigh the cost versus risk and in this case it does not make sense. Good due diligence (market, management, suppliers, customers, etc.), a realistic cashflow analysis, basic balance sheet info, good security and a well-informed and prepared Credit Officer are all that is needed.

Below is a sample of a Cashflow Tool. This should be adapted for your own use.

CASHFLOW ANALYSIS for Individual Loan				
Business Name:		**Client Name:**		**Doc used for verification / Comment**
	Amount			
BUSINESS				
Income from Sales	**Daily Items**	**Weekly Items**	**Monthly Items**	
Business 1				
Business 2				
Business 3				
Total Business Income	-	-	-	
Expenses				
Raw materials business 1				
Raw materials business 2				
Raw materials business 3				
Salaries				
Rent				
Utilities (electricity, water, kerosene, charcoal)				
Transportation				
Fuel				
Food at workplace				
Loan Payments				
Others				
Total Business Expenses	-	-	-	
Net Business Income (Income - Expenses)	-	-	-	
Monthly Equivalent of Net Business Income (Daily x # of days per month worked and Weekly X 4)	-	-	-	
Total MONTHLY Net Business Income			-	
HOUSEHOLD				
Regular Household Income				
Salaries				
Pension				
Other Income (regular)				
Total Household Income	-	-	-	

Expenses				
Food				
Water				
Electricity				
Kerosene				
Charcoal				
Education				
Housing/Rent				
Transportation				
Clothing				
Medical				
Insurance				
Telephone / Cell				
Loan Payments				
Other:				
Other:				
Total Household Expenses	-	-	-	
Net Household Income (HH Income - Expenses)	-	-	-	
Monthly Equivalent of Net Household Income (Daily x 28 and Weekly X 4)	-	-	-	
Total MONTHLY Net Household Income			-	
TOTAL Business and Household		**NET INCOME MONTHLY**	-	
Adjusted Repayment Capacity: (50 %)			-	
Maximum Loan Amount Possible				
Term (# of months)				
Loan Payment per month				

Prepared by:______________________________ Date: ____________________

	Formula		**Before Loan**	**After Loan**
Total Inventory				
Inventory Turnover (days)	(inventory*28) / (weekly raw materials *4)			
Working Capital	Current Assets - Current Liabilities			

CASHFLOW ANALYSIS TOOL DESCRIPTIONS

<u>DETAILS OF COLUMNS:</u>

1st column (Items): Line items for income and expenses which are defined below.
2nd column (Daily Items): Income and expenses which are made on a daily basis.
3rd column (Weekly Items): Income and expenses which are made on a weekly basis.
4th column (Monthly Items): Income and expenses which are made on a monthly basis.
5th column (Documents used for verification / comment): The name of the support documentation and receipts verified by the Credit Officer for each line item showing the actual costs incurred. If possible, copies of these should be filed in the clients files as well. The comment section could include information about on-time or delinquent payments for line items.

DETAILS OF ROWS:

BUSINESS

The Credit Officer should collect real information from the last full month of business operations, from the 1st of the month to the last day of the month. In this manner, all of the financial information for one full month will be collected.

Important note: Generally, the Credit Officer should have a good grasp of various types of businesses after a few months of work in the field, such that, s/he would know the business type, size of business and be able to make a comparison to other similar businesses. A good Credit Officer would have a relatively good idea of the appropriate level of sales, cost of raw materials and expenses, and be able to compare this to the business s/he is evaluating.

Income from Sales

This refers to any income from cash sales that the business receives. It is divided up according to the business or products that the business operates (i.e. if the client has a hair salon and grocery, these would be Business 1 and Business 2, respectively).

Business 1: Fill in the income received daily, weekly or monthly. If the client has written records, tally the monthly total and complete the monthly column. For most small businesses, the client will not have written records. In these cases, it is more prudent to fill in the weekly sales, as this will be easier for the client to remember. The Credit Officer should start by asking the approximate weekly sales total and note this down. Then the Credit Officer should continue by asking questions from a different angle. Go through the week day-by-day. Start with the most recent day and work backwards in the week. Ask, "What were your sales yesterday, the day before, Monday, Sunday, Saturday, Friday and Thursday?" The Credit Officer should add these figures and compare the result to what the client said his/her sales were for the full week. If they are similar, the Credit Officer has verified the figures in two different ways. If there is a big difference, the Credit Officer should delve deeper to understand the discrepancy. Often, it is just a matter of the client not knowing the weekly sales figures. Also, the Credit Officer should check to see if the week that the client is quoting from is in a low or high season (remember this question from the Loan Appraisal Tool).

Business 2: Same as above for Business 1

Business 3: Same as above for Business 1

Total Business Income: The sum of the daily, weekly and monthly sales income from the various business lines. Calculate the final totals at the end of each column. Finally, the daily and weekly columns will be computed into a monthly equivalent.

Business Expenses

Business expenses include expenses for the business only, and are broken down into direct (raw materials) and indirect expenses (overhead and other).

Raw materials business 1: to calculate this expense, the Credit Officer will have used the worksheet from the Loan Appraisal Tool to properly calculate the raw materials expenses for each line of business. For retail and trade businesses, the Credit Officer would have used the "Worksheet for Cashflow Analysis", on page 7 of the Loan Appraisal Tool. For manufacturing and production businesses, the Credit Officer would have used the "Cost of Goods Sold Breakdown", on page 8 of the Loan Appraisal Tool. The Credit Officer would transpose these numbers from the Loan Appraisal Tool into the Cashflow Analysis Statement Tool.

Raw materials business 2: Same as above for Raw materials business 1

Raw materials business 3: Same as above for Raw materials business 1

Salaries: This includes any cash payment (or sales price of goods given instead of cash) for salaries to employees or family members that are allocated to general overhead. This does not include items already summed in the COGS. These could be daily, weekly or monthly expenses.

Rent: For a business premises, rent is usually a monthly expense. If the business and house are in the same place, the rent would be broken down by the approximate space used for each. The total rent for the building should be noted and the proportion for each documented with the reason.

Utilities (electricity, water, telephone, cell phone, other): Refers to the amount paid from the business income for utilities services. The Credit Officer should note the separate expenses on the back of the form and then tally them before transferring the total to the cashflow. This does not include items already summed in the COGS. This is generally a monthly expense, but could be daily or yearly.

Transportation: Refers to the amount paid for transportation of employees and goods during the month (e.g. vehicle maintenance, taxi fare, trucks for goods, etc.). This is generally a daily expense item. It does not include items already summed in the COGS.

Fuel (petrol, diesel, other): Refers to the cost of fuel paid by the business for transporting goods in a vehicle owned by the business. It does not include items already summed in the COGS. This is usually a daily or weekly expense.

Kerosene, charcoal, other: Refers to the cost of items used for heating and cooking. It does not include items already summed in the COGS. This is usually a daily or weekly expense.

Food at workplace: If the business provides food for workers or Managers, then it would be included in this line item. It is usually a daily expense.

Loan Payments: Any other payments to money lenders, family members or financial institutions for business borrowings are included here. The Credit Officer really needs to dig to get this information from the client. The Credit Officer must make the client understand that having another loan does not preclude them from borrowing at your MFI. In fact, if they have a good credit history, it would help their cause. Also, the client should understand that if they do not divulge this information it may make their loan payments impossible to repay due to the miscalculation of the expenses and therefore repayment capacity.

Others: Any other expenses which the business incurs should be included here. If the Credit Officer or MFI discover that there is a usual expense, which is reoccurring for many clients, this should be added as a line item so it is not forgotten (i.e. taxes).

Total Business Expenses: The business expenses are then summed up in the columns going down, daily, weekly and monthly.

Net Business Income (Total Business Income - Total Business Expenses): The Total Business Income less the Total Business Expenses is tallied for each column, daily, weekly and monthly.

HOUSEHOLD

Household Income

Regular Household Income: Refers to income which earned on a habitual basis whether it is daily, weekly or monthly. Not seasonal income.

Salaries: Here the Credit Officer would ask what each family member who regularly contributes to the expenses of the household earns and how much of this is actually contributed to the household.

The fact that a family member lives in the household and earns a regular income does not mean they actually share the entire income with the family. The Credit Officer needs to distinguish the income as it could artificially inflate the income for the household. The income should be verified through earning statements, bank deposits, etc.

Pension: Refers to a verifiable pension received by one of the family members contributing to the household.

Other Income (regular): Any other regular income contributed to the household.

<u>Household Expenses</u>

The Credit Officer should know and/or the MFI should set an approximate monthly expenses minimum for families, depending on their size. It is important to make sure that at least the minimum total expenses are being recorded on the cashflow and that clients are not cutting corners on expenses in order to receive larger loans.

Food: Refers to the amount spent on purchasing food items. This row should list daily, weekly, and monthly purchases. Multiply daily food purchases by 28 days.

Utilities (water, electricity, kerosene, charcoal, or other): Refers to the amount paid from the household income for utilities services such as light, water, and telephone. This is generally a monthly expense. These are separated in the Cashflow Tool.

Education: Refers to the amount paid for schooling during the month, including school fees, uniforms and other school clothing, books, other fees, and transportation. Note that some school fees are paid monthly or three/four times per year. In either case, use the total amount paid per year for all school fees and school clothing and divide by 12 to arrive at the average amount paid per month for these items. Multiply by 28 days the daily costs of the students' daily meal allowance and/or transportation and add this figure to the monthly education expense. This could also include expenses for school uniforms.

Note: It is very important for the MFI to understand the school fee structure and the affect these have on the delinquency rates during the school payment months. Thus, the MFI may want to include the full term fees in the monthly calculation so that there is enough cash, a cushion, during the school fees payment months.

Housing/Rent: Refers to the amount paid for rent or housing amortization where the applicant resides. This is generally a monthly expense.

Transportation: Refers to the amount paid for transportation for family members (excluding children attending school and business-related transport) during the month (e.g. vehicle maintenance, fuel, taxi fare, etc.). This is generally a daily expense item.

Clothing: Refers to the amount paid for clothes in the household and is generally a monthly expense.

Medical: Refers to the amount allocated for visits to the doctor or dentist, surgery, medicine purchases, health care premiums, among others. The Credit Officer should ask the family how much they have spent over the last week, month and year to get a general figure.

Insurance: Refers to the cost of health, life and accidental insurance.

Telephone: Refers to the charges for a fixed line or cellular phone. In many cases, this may not be relevant.

Loan Payment (consumption loan): Refers to consumption loan payments that are made daily, weekly and/or monthly by the household.

Other (Household) Expenses: Refers to additional household expenses, paid but not included in the above categories. These could include home repairs, recreation, parties, celebrations, weddings, funerals, household emergencies, etc.

Q: How is the Cashflow Analysis Tool completed?

Once the daily, weekly and monthly income and expenses are recorded according to the above criteria, the Credit Officer:

Business section:

1. Sums the total business income for each column, daily, weekly and monthly.
2. Sums the total business expenses for each column, daily, weekly and monthly.
3. Finds the Net Business Income for each of the 3 columns by subtracting the total business expenses from the total business income (i.e. total daily business income – total daily business expenses = total daily net business income). Completes for the weekly and monthly columns as well.
4. Enters the daily "Monthly Equivalent of Net Business Income" by multiplying the total daily net business income by number of days in the month worked or 28 (whichever is lesser).
5. Enters the weekly "Monthly Equivalent of Net Business Income" by multiplying the total weekly net business income by 4.
6. Calculates the Total MONTHLY Net Business Income by adding the daily and weekly "Monthly Equivalent of Net Business Income" and monthly net business income.

Household section:

7. Do the same as in steps 1 – 6 for the household income, expenses and net income.

Total section:

8. Calculate the Total Business and Household Net Income Monthly by adding the Total Monthly Net Business Income and the Total Monthly Net Household Income.

Repayment Capacity section:

9. Calculate the Repayment Capacity per Month by multiplying the Adjusted Repayment Capacity by Total Business and Household Net Income Monthly.

Ratio section:

10. The remainder of the Cashflow Tool will be covered in Session 8 Loan Structuring.

Q: Should larger loans have a different analysis process?

For larger loans (over $3,000) there is a higher risk factor. Thus, the cashflow should be a bit more substantial with 3 months historical data. MFIs may also choose to increase collateral requirements for larger loans. See BRAC Bank Limited example below.

For loans over $3,000, the Loan Appraisal Form will remain the same. Only the Cashflow Statement will change to capture the previous three months of historical data. The Credit Officer must capture each month of information in a monthly format. The business must be able to produce historical information or at least recall historical information for at least three months. **The Credit Officer should not complete Month 1 and then just copy this information across.** The data should be collected and calculated for each month. There may be variances in income and expenses that need to be documented.

After capturing the three months of historical information, the Credit Officer should compare each line item, sub-total and total to see if there are any great variances in figures that would make averaging the months a potential problem for repayment. If they are similar, the three months' "Total Net Incomes" should be summed and then averaged. This Total Net Income average will then be used to calculate the "Adjusted Repayment Capacity".

BRAC Bank Limited Micro and Small Loan Product Details:

ANONNO 1 (micro loan): This loan product is designed for micro business enterprises for additional working capital and/or fixed asset acquisition. The target customers are small trading, manufacturing, service, agriculture, agro-based businesses throughout the country. The product is made available through the bank's branches and unit offices.

ANONNO 2 (small loan): The terms and requirements for this type of loan are generally similar to the micro loans. The key differences are that the loans are larger, an income statement and a balance sheet are required for analysis, the credit unit of the department prepares a risk evaluation sheet, and additional collateral is required. **All other terms and conditions are the same.**

For loan requests greater than $ 8,300, simple financial statements are made by the Credit Officer, but **fleshed out cashflow estimates are not prepared. Ratio analysis is hardly, if at all, used to analyze the statements and few financial projections are made to estimate cash generation capacity of the borrowing enterprise. There is reliance on the ratio, which indicates cash available to pay the loan.**

Seasonality of sales is taken into account and family expenses are also considered in the estimation of net income for both types of loan. The maximum loan amount cannot exceed 75% of the sum of average inventory plus goods receivable, if any, of the previous year and the monthly repayments cannot exceed 75 % of estimated monthly net income.

Below is a sample of a Cashflow Tool for larger loans. This should be adapted for your own use.

CASHFLOW ANALYSIS for Individual Loan OVER $3,000				
Business Name:		**Client Name:**		**Doc used for verification / Comment**
	Amount			
BUSINESS				
Income from Sales	**Month -3**	**Month -2**	**Month -1**	
Business 1				
Business 2				
Business 3				
Total Business Income	-	-	-	
Expenses				
Raw materials business 1				
Raw materials business 2				
Raw materials business 3				
Salaries				
Rent				
Utilities (electricity, water, kerosene, charcoal)				
Transportation				
Fuel				
Food at workplace				
Loan Payments				
Others				
Total Business Expenses	-	-	-	
Net Business Income (Income - Expenses)	-	-	-	
Monthly Equivalent of Net Business Income (Daily x 28 and Weekly X 4)	**not filled in for loans over $3,000**			
Total AVERAGE MONTHLY	**Net Business Income**		-	

HOUSEHOLD				
Regular Household Income				
Salaries				
Pension				
Other Income (regular)				
Total Household Income	-	-	-	
Expenses				
Food				
Water				
Electricity				
Kerosene				
Charcoal				
Education				
Housing/Rent				
Transportation				
Clothing				
Medical				
Insurance				
Telephone / Cell				
Loan Payments				
Other:				
Other:				
Total Household Expenses	-	-	-	
Net Household Income (HH Income - Expenses)	-	-	-	
Monthly Equivalent of Net Household Income (Daily x 28 and Weekly X 4)	**not filled in for loans over $3,000**			
Total AVERAGE MONTHLY	**Net Household Income**		-	
	TOTAL Business and Household	**NET INCOME MONTHLY**	-	
Adjusted Repayment Capacity: (50 %)			-	
Maximum Loan Amount Possible				
Term (# of months)				
Loan Payment per month				

Prepared by:______________________________ Date: ____________________

	Formula		**Before Loan**	**After Loan**
Total Inventory				
Inventory Turnover (days)	(inventory*28) / (raw materials)			
Working Capital	Current Assets - Current Liabilities			

The reader should review and keep in mind the following list when creating and reviewing cashflow statements:

Checklist for Reading Cashflows

☐ Check the beginning cash. Is it reasonable? Does the client really have the cash in hand? Did the Credit Officer see the cash?

☐ Check that sales are reasonable compared to other similar businesses. Verify with written records if possible. Verify with cash in register at the end of the day to get an idea of daily sales. Verify with suppliers, customers and sales clerks.

☐ Check that raw material unit costs and total costs are reasonable compared to market prices and other similar businesses.

☐ Look at other business expenses to see if they are reasonable compared to market prices and other similar businesses.

☐ Make sure that all business expenses are included and that nothing was forgotten. Think of other similar businesses and compare. Ask probing questions about other possible expenses.

☐ Look at the largest figures and see if they make sense.

☐ If it is a seasonal business, be sure to take into consideration which month you are currently completing the cashflow and low season months. Will the client be able to pay in low season?

☐ Verify any other household income by receipts, earnings statements, bank account statements, etc.

☐ Look at other household expenses to see if they are reasonable compared to market prices and other similar businesses.

☐ Make sure that all household expenses are included and that nothing was forgotten. Think of other similar businesses and compare. Ask probing questions about other possible expenses.

☐ Make sure that all household expenses are included and that nothing was forgotten. Think of other similar businesses and compare. Ask probing questions about other possible expenses.

☐ Check ratios. Do they make sense? Are they within the limit?

Red Flags:

- Make sure to ask questions about income and expenses from different points of view to compare the figures and make sure that the client is remembering correctly.
- Credit Officers should have a good idea of types of businesses, sizes and relative sales, expenses of such businesses.
- Credit Officers should have a good idea of the average expense for a particular size family living in relatively similar conditions and compare this to the figures given by the client. This may need to be adjusted according to norms.

Below is a Real Case:

Pretend you are the Credit Officer for this business. Below is all the information that you have gathered to present to Credit Committee, which is in two days. You must complete the following items:

1. Read the case and application
2. Complete a SWOT Analysis.
3. Write the deal up on the (blanks attached):
    a. Credit Investigation Form
    b. Cashflow Worksheet
    c. Cashflow Analysis
    d. Calculate the Inventory Turnover and Working Capital
4. Decide what loan amount, loan use, term and payment frequency.
5. Decide what conditions you would set for the borrower.
6. Present the deal to Credit Committee for approval.

> **Note:** For this exercise we have set the "Adjusted Repayment Capacity" at 50% of the Total Net Income for both Business and Household. Depending on the MFI, country environment and client situation, this can be adjusted. It usually is within the 75% to 25% range. Some MFIs use 75% across the board. Others use 25% for new clients and 50% to 75% for second and third time good clients.

OK, let's get started.

Company's Name	Grocery #1	**Borrower's Name**	Stephen Kabonero
Company's Address	Alley 2, #13	**Borrower's Address**	Alley 2, House #9, Flat #18
Company's Telephone		**Borrower's Telephone**	077-555-555
Other Contact Name & #	Godfrey Peter		
Type of Business	Grocery Shop		
Legal Structure	Registered		
No. of employees	2 present / 3 planned		
Ownership	Stephen – 100%		
Loan Amount applied for	2,000,000		
Loan term applied for	12 Months		
Interest rate	30% per year flat		
Frequency of payment applied for	monthly payments		
Bank Branch	ABC MFI, 1 branch		
Bank Loan Officer	George Okwir		
Today's Date	November 2003		

1. **PROPOSED PROJECT:**
    - A grocery shop opened 6 months ago with owner's investments of land/building, shelves, desk, cash register and inventory for the shop. Currently, the shop is functioning, but its sales are low because of the small assortment of inventory. There is no deli-refrigerator and therefore no meat products in the shop. Dairy, confectionery and alcohol products are limited in quantity and variety. With the loan, the borrower plans to purchase a refrigerator for the frozen, dairy, and meat products, increase inventory assortment and buy a generator.
    - The client wants to take advantage of the high Christmas sales opportunity.
    - The client applied for a loan 6 months ago, but was told to build some sales history and account history with the bank before asking for credit.

Project Costs (in '000 Ush):

Item	**Owner's Contribution**	**Loan**	**Total Project Cost**
1. Inventory for grocery shop	1,000 (current inv)	1,000	2,000
2. Refrigerator		500	500
3. Generator		500	500
Total	**1,000**	**2000**	**3,000**
% Share	**33%**	**67%**	**100%**

2. **COLLATERAL:**

Item	**Acquisition Cost**	**Date**	**Market Value**	**Liquidation %**	**Liquidation Value**
1. Shop Building	4,650	1999	3,000	50%	1,500
2. Owner's house (3 rooms)	1,800	1988	2,500	50%	1,250
3. Personal guarantee from owner(s) of the business.					
TOTAL LIQUIDATION VALUE					**2,750**
Total Liquidation Value / Total Loan Value (LTV)					**138%**

3. HISTORY OF BUSINESS AND PROJECT DESCRIPTION:

Business History and Description:

- Construction started in September 2002 and was completed in May 2003 on land purchased through an auction. It is 42 m^2 of which 25 m^2 are used for the trading space and the remainder is used for the office. According to the owner 4,650,000 Ush was spent for building and equipment in the shop (3,500 – the owner's contribution, 1,150 – loan from a very close relative with unlimited time, so no interest payment).
- Opened in June 2003 the grocery store is in an excellent location, surrounded by several apartment buildings, from which it is the nearest shop. The owner does the buying and stocking and his wife is the sales person and bookkeeper. The owner supplies the shop using his own car and buys products from local markets and a bread factory. The borrower was a traffic policeman previously, and has a lot of friends and a nephew who are bus drivers. They deliver goods from neighbouring cities at below market cost. He does not have transportation expenses.
- It is open 7 days a week.
- The owner plans to build an open café in 6 – 12 months on the shop's land.

- **Credit History:** None other than while building the shop, Stephen borrowed 1,150,000 Ush from a relative for construction materials.

Owner/Managers Qualifications and Experience:

- Stephen, the owner is 42 years old with general technical secondary education. From 1986-99, he worked in the Traffic Police Department, where he became an invalid as a result of a car accident. In spite of this, he leaves the impression of a strong and energetic person, as he implements the supply of goods several times per day. The fact that he has even recorded unimportant expenses during the building process, creates a positive impression.
- Angela, Stephen's wife - carries out the sales function. She received her education from the Trade-Technical Institute and has worked in several trade shops as a cashier.
- The management deserves a high evaluation for diligent bookkeeping.

Suppliers:

- Currently, the shop has only several suppliers because of its limited assortment. The main supplier is "Metropolis Ltd" (drinks, juice, canned goods), "Aia Ltd" (rice, beans, flour, dairy and bread), local wholesale bases. Every supplier accepts only pre-payment for the good supplied. The borrower has no goods on credit.
- With the loan, the borrower plans to purchase inventory - meat products and sausages from local producers, beverages from local wholesale markets, oil, sugar, canned goods, flour products and confectionery from the wholesale market. The suppliers accept cash payments. The borrower does not plan to buy products on credit, as he gets about a 10% discount with cash payments. Most goods he buys weekly, including those from the neighbouring towns' wholesale markets with the help of his nephew and friends, who are bus drivers. With the loan, he would like to purchase dairy, meat and bread more often.

Customers*:*

- The customer base of the company consists of 6 apartment buildings around the shop with about 350 families. This is about 2,100 people.
- The shop is convenient for the customers, due to its location. The prices are low. Currently the demand is not fully met, because of the limited assortment.
- There are a few goods sold on credit, but none are older than 4 days or over 10,000 in total per person.

Competition:

- The borrower's main competitors are three other small grocery shops. The nearest of them is 500 meters away from the apt blocks. They have comparatively more experience. The Credit Officer saw two of them and interviewed one shop owner. The competing shops have a richer assortment and about 25% more inventory.
- The advantage of Stephen's shop is that it is located closer to the customers. Also, the shop is newly built and has a nice interior, whereas the others are of the old style where customers have to order from outside the bars.
- To attract customers, the owner supplies his shop with bread three times per day and will do the same with dairy/meat products.

Item	**Borrower's Cost per *item***	**Borrower's Sales Price per *item***	**Gross Margin %**	**Quantity Sold per month**	***(Competitor)'s* Sales Price per *item***	**% Difference btwn Borrower's & Competitor's**
Soda	400	500	25%	38	500	0%
Rice	1100	1350	23%	15	1400	4%
Flour	650	850	31%	20	1000	18%
Soap	750	900	20%	9	1000	11%
Bread	900	1000	11%	12	1000	0%

Seasonality/Cyclicality:

- The seasonality is considered on the basis of other shops' experience, as the borrower is newly established. From their experience, the seasonality in such shops (which are located nearby apt buildings) is more significant than for those in the city centre. For example, if in dry season, central shops decrease sales by 5-10%, in the outskirts, they decrease by 15%. High season is before the Christmas Holiday, when they increase by 20%. Other months are almost stable, except for the dry season.

Site Visit:

- The Credit Officer visited the company on December 2, 2003 at 12 in the afternoon. The shop is newly renovated. The space for trading is tiled. The lack of assortment is obvious. The owner keeps a small part of the inventory at home in storage. The owner currently uses a small family refrigerator for selling the dairy. The shop does not have meat products or alcoholic products. The visit period coincided with the owner bringing in the bread for the second time during the day. The Credit Officer saw the financial records of the owner. In 15 minutes, 4 local customers visited the shop and spent a total of 8,500. In the drawer there was 20,000, including these customers' purchases.
- In future, the owner would like to build a veranda and a café in the front of the store. The shop's location nearby the apt buildings makes this a good prospect and there are no other cafes within 1 km.
- A surprise visit was made on December 4th at 4 pm. There was 60,000 in the till and 3 customers came into the shop while the Credit Officer was there. The shop is open from 9:00 am until 9:00 pm.

Other relevant information:

- Inventory 6 months ago: 300,000
- The owner expects to triple his sales with the new inventory, as customers will not need to go to the shops further down the road because he will have everything they need and for less. Electricity goes out about three times per week for a few hours each time.
- Savings: no savings 6 months ago. Now at MFI ABC, savings equal 475,000 and have been increasing steadily over the last 6 months. There are no other savings.
- Children's education: 100,000 per term paid in October, January and March
- Other assets: furniture & appliances = 1,500,000. The liquidation value and accounts receivable = 50,000.
- Other liabilities: zero.
- Business expenses average: Fuel per week = 6,000. Utilities per month = 20,000. Car maintenance per month = 10,000.
- Average household expenses: clothing per month = 10,000. Transport per day for son = 1,000. Utilities per month = 16,000. Food per day = 7,000
- Other income: son makes 250,000 per month working at a NGO and 3,000 per day (7 days a week) selling produce.

- **REFFERENCES:**

Company/Contact	Type of Cooperation	Term of Cooperation	Date Credit Officer Contacted Referee	Comment of Referee
1. Individual	**customer**	**6 months**	**Dec 4**	**Low cost. Location convenient. Bread's always fresh.**
2. Aia	**Supplier**	**6 months**	**Dec 4**	**Always pays cash and gets 10% discount.**
3. Metropolis	**Supplier**	**6 months**	**Dec 4**	**Always orders ahead and pays cash upon pick.**
4. ALLEY #2	**Competitor**	**None**	**Dec 4**	**Sales have been lower for flour, rice and beans, but I still have an advantage in that I sell more variety.**
5. LCI	**Local leader**	**Since 1988**	**Dec 4**	**Good citizen. Always contributes for funerals.**

5. SWOT ANALYSIS:
Strengths:

Weaknesses:

Opportunities:

Threats:

Other Comments:

Session 6: Financial Statement Analysis for Lenders

Q: What is an income statement?

The Income Statement, also known as the Profit and Loss statement (P&L), matches all revenues with corresponding expenses over a specific period of time and reports the company's profits (i.e. excess of revenues over expenses). It tells you how well the company buys and sells its products or services to make a profit.

The Income Statement reports how the company's financial condition is changing over time. It gives strong clues about how well the company can survive in the future.

Q: What is the difference between an income statement and cashflow?

The key differences between the income statement and cashflow are that the income statement records transactions (movement of goods: both sales and purchases in cash AND on credit) and depreciation, whereas the cashflow records movement of CASH ONLY.

Q: Why are we not using an income statement in this methodology?

For most micro businesses, the cashflow and the income statement are almost the same for any given month. Smaller businesses often have negligible amounts of accounts receivable, accounts payable and depreciation. First, credit from suppliers (accounts payable) is not usually given to micro businesses. Second, although it is assumed that most businesses, even the smallest businesses, have some sales to customers on credit (accounts receivable), it is up to the Credit Officer to make sure that s/he understands the accounts receivable and the aging of these items (is the time period reasonable?). It is more conservative to use the cashflow, as some accounts receivable may never be paid. The last point is that a cashflow illustrates the cash income and outflow and the current amount of cash available today. A business could be running fantastically according to the income statement, but have no cash coming in. For example, the business could be generating a lot of sales, but the sales are all on credit. The important point to emphasize here is that only cash repays the loan.

If the Credit Officer comes across a business with high accounts receivable and/or payable, it is most important to ensure that the time periods for payment of these accounts match or are in the borrower's favour. The time periods match closely in a business that turns the product around very quickly. In a trade business for example, goods can be purchased on credit from a supplier and paid for 60 days later. The business may also sell products to customers on credit and receive payment 60 days later.

If a business does not have very quick inventory turnover (a production business, for example), there could be a mismatch between the time periods for paying suppliers and receiving customer payments. For example, the client may receive raw materials on credit for 60 days, spend 30 days producing an item, and then sell the product on 60 days credit. In this case, there would be an unfavourable mismatch of 30 days because accounts receivable is 90 days (30 days for production + 60 days for customer payments) and accounts payable are 60 days. **Note:** This calculation does not include possible delinquent payments from customers or the client, which are very often the case.

If the time period for payments matches the time period for receipts and the business is not drastically affected by seasonality, then the cashflow should still suffice for repayment calculations. If not, this is a large risk. The Credit Officer would need to make sure that the cash coming in is enough to cover the repayment and that accounts receivable are not growing, but are constant.

It is less risky for a MFI if the client buys and sells in cash or at least if the mismatch is in their favour. When a mismatch happens in favour of the borrower (i.e. the client buys supplies on 60 days of credit and customers pay for them in cash), the client is financing part of his/her working capital in essence, for free. This arrangement is like a short-term interest free loan.

Credit officers must also know what is behind the accounts payable and receivable figures on the balance sheet. Who are the suppliers and creditors? Are these collectable? Is the client paying on time or are they behind? Why have they not been paid? What is the age of these items? A short schedule of all the payables and receivables is usually made for larger loans and includes the names of the suppliers and creditors, date taken, amount owed and whether or not it is late. All payables would be included on the balance sheet. However, only accounts receivable that are likely to be collected are included on the balance sheet. Essentially, the overdue or uncollectible accounts receivable are written off.

The last point about income statements (over multiple periods such as 12 months or more), is that the Credit Officer is able to look for trends in sales, cost of goods, expenses, and accounts receivable and payable. Using the individual lending methodology in this toolkit, we are not able to do this analysis for a first-time loan. The cost of collecting this information does not offset the associated risk of not doing it. More importantly, most businesses do not have the ability to provide the required information, due to a lack of written records. Eventually, with multiple loans to one customer, this individual lending methodology will enable a Credit Officer to complete a trend analysis of the business by comparing information for each loan, including loan terms, assets, liabilities, equity, cashflow (including sales and expenses) and financial ratios. The Repeat Loan Evaluation form helps the Credit Officer to do this. This form is discussed in *Session 4, Handout 4.9*.

Q: What is the balance sheet?

The balance sheet is a snapshot of the company at one point in time. There are three parts to the balance sheet:

1. Assets
2. Liabilities
3. Equity

These are arranged in a table with assets on the left and liabilities and equity on the right. The simple equation for the balance sheet is:

Assets = Liabilities + Equity

What are a company's assets?
Assets are items of value, such as cash, inventory, machines and buildings that the company owns.

What are a company's liabilities?
Liabilities are items that the business owes to other parties, such as a MFI loan, loan from a family member, and money owed to suppliers.

What is the company's equity?
Equity is the financing of the company's assets that has been provided by the owners of the business, as well as the cumulative profits of the company. It is also called net worth.

Think of assets as USES of funds, and Liabilities and Equity as SOURCES of funds.

Trainer's notes: So often, the simplest mistake is made by the Credit Officers over and over again - the balance sheet does not balance! It must balance, thus the name balance sheet! For any transaction, there are at least two effects on the balance sheet. For example, if a business buys a cash register, the cash is reduced and the equipment is increased by the same amount.

Five Key Questions the Balance Sheet can answer:

Does the company collect? -- Look at accounts receivable. What is the quality? What is the aging?

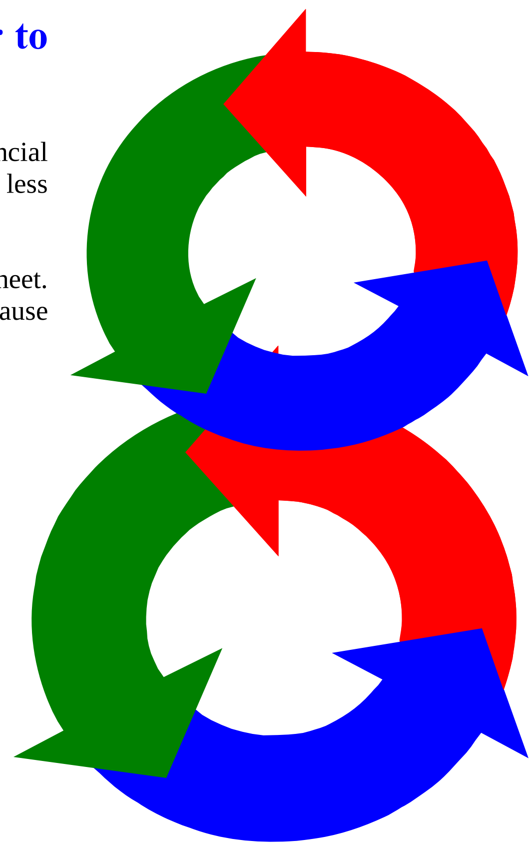
Does the company pay its bills? -- Look at accounts payable and days accrual. What are the terms? Does the owner pay on time? Are days payable < inventory?

Does the company control its inventory? Are the day's inventories nearly equal to the inventory cycle?

Are the officers of the company committed? Did they contribute equity or "sweat equity"?

Does the company have a profitable operating history? Are the retained earnings positive?

Q: Why is it important for a lender to understand the balance sheet?



The balance sheet usually shows you the financial problems of the company – especially the ones that are less apparent.

Many borrowers do not understand the balance sheet. Often the owner of the business is very happy because profits are up and sales are up. Sales and profits do not pay back a loan; only cash repays!

The company may be making a profit, but all the profit may be sitting in assets like accounts receivable and inventory. The inventory may have gone bad. Customers may be taking a long time to pay the business. The Loan Officer needs to analyze the balance sheet to understand the Operating Cycle.

The Credit Officer should not focus on the balance sheet alone. Liabilities (loans or accounts payable) get converted into assets, such as inventory and accounts receivable. These assets are sold and generate income. The income gives the business cash to buy assets and repay the loan. When the business borrows, the cycle begins again. This is known as the Operating Cycle or the Cash-to-Cash cycle.

Q: What is the standard format for a Balance Sheet?

The standard and most used balance sheet format guided by the international general accounting principles is assets on the left side, and liabilities and equity on the right side.

The assets listed begin with the most liquid (i.e. cash) and run down to the most non-liquid.

The liabilities and equity begin with the most "impatient capital", such as short-term loans, which must be repaid soon. The list ends with the most "patient capital" (equity, for example).

Equity is made up of the original investment into the business, plus any profit/loss. The basic formula for equity is:

Equity = Assets – Liabilities

Exercise: Readers should rearrange the balance sheet below into the correct format: assets on the left, from most to least liquid, and liabilities on the right, from what needs to be paid most quickly to least quickly.

Water Bottling Inc.
Balance Sheet
Dec. 31, 1998

Liabilities and **Equity**		Assets	
Long-term bank loans	$ 500	Cash	$150
Taxes payable	$ 50	Investments in subsidiaries	$200
Retained earnings	$??	Net equipment	$500
Accounts payable	$ 100	Accounts receivable	$ 50
Short-term bank loans	$ 100	Inventory	$300
Balance		*Balance*	

Answer:

Water Bottling Inc.
Balance Sheet
Dec. 31, 1998

Assets		Liabilities and Equity	
Cash	$ 150	Accounts Payable	$ 100
Accounts Receivable	$ 50	Taxes Payable	$ 50
Inventory	$ 300	Short-term bank loans	$ 100
Current Assets	***$ 500***	***Short term Liabilities***	***$ 250***
Investments in subsidiaries	$ 200	Long-term bank loans	$ 500
Net equipment	$ 500	***Long-term Liabilities***	***$ 500***
Fixed Assets	***$ 700***	**Equity (retained earnings)**	***$ 450***
Total	**$ 1,200**	**Total**	**$ 1,200**

Review the Water Bottling, Inc. Balance Sheet exercise. Notice any positive/negative indications, or problems. You should see the following items:

1. The current (short term) assets are greater than the current liabilities, indicating that the company can cover its short term liabilities without running into liquidity problems (running out of cash).
2. The long-term assets are greater (investments and equipment) than the long term liabilities, indicating that the company can cover its long term liabilities.
3. Accounts receivable need to be checked for age to see if they are still good. They should not be carried onto the balance sheet if there is little hope of collection.
4. Inventory should be verified manually and checked to see if there are any expired or damaged goods. For more information regarding verifying inventory, refer to the section in *Session 4*, "How is the inventory information and figures collected and verified?"
5. Age and due dates of accounts payable and taxes payable also need to be checked in order to avoid potential problems. If a client is not paying their accounts payable or taxes, then they will most likely not repay their loan. Typically, if a client were to prioritize payments, a loan would be the last item to be paid after suppliers and taxes. Keeping inventory in stock and staying open is more important than being on time repaying a loan.
6. The business has both short and long-term loans outstanding. This could be one loan that is broken up with the principal payments due in less than one year (short term loans payable) and over one year (long term loans payable). In this case, the loan(s) will not be paid off within the next year. Credit Officers should consider short and long-term loans outstanding, when judging the repayment capacity of a business, as these are additional expenses that could affect its ability to repay.
7. Equity is positive, meaning that there are either positive profits and/or owner investment. From this balance sheet, one cannot determine whether there are positive profits and/or positive owner investment. The owner's new investments could be covering up cumulative negative profits, making the equity positive. The Credit Officer should try to discern the owner's investment from profits and see the trends of each. Hint: increasing cumulative profits and higher owner investment are good for business; decreasing cumulative profits and depleting of equity are bad for business.

Important Balance Sheet Learning Points:

Short-term expenses and working capital require short-term sources of capital.
Long-term loans can be used for long-term assets.
Accounts payable and receivable need to be checked and verified.*
Inventory needs to be checked and verified.*
Loans payable need to be checked and verified for good repayment.*
* See discussion below regarding verifying information under question: "What are tips for collecting the information on a Balance Sheet?"

Below is the format which will be used for this individual lending product. Also, refer back to the Loan Appraisal form. The balance sheet should always start with the "business's name" and the "as of date."

Business / Entrepreneur's name
Balance Sheet as of DATE

Assets		Liabilities and Shareholders Equity	
Cash		Accounts Payable	
Current Accounts		Other payables	
Savings		Bank loans	
Accounts Receivable			
Prepayments			
Raw Materials			
Inventory		***Total Liabilities***	
Moveable and Fixed assets		**Equity**	
Total Assets		*Total Liabilities and Equity*	

Balance sheets for production businesses are more complex. The inventory is broken down into many different levels including raw materials, partially finished goods and finished goods. This is very important because raw materials have a much different value than finished goods, which include raw materials, transport and labour. A credit officer must evaluate this when s/he is taking inventory of the business, and value it accordingly

Q: Why do companies need debt?

Companies need debt because profits from sales often do not generate enough cash when needed.

For example, a business needs to buy a major piece of equipment or it receives a large order that needs to be filled quickly. The business does not have enough cash to purchase the equipment or inventory at this moment.

Q: Why do companies need cash?

Companies need cash to pay for operating expenses including rent, utilities and loan repayments. They need cash to support working capital needs, such as inventory, accounts receivable and wages, and to purchase fixed assets, such as machines. Cash is also necessary for paying expenses due to unforeseen circumstances.

Q: Which do you think is more important for a business from the Loan Officer's point of view: Profits or Cash?

Both are important, but for the Loan Officer, it is cash that repays the loan.

"A business is like a human being in that cash is its oxygen and profits are its water". A person needs both oxygen and water to live, just as the business needs both cash and profits. A person can live for a whole week without water, but only a couple of minutes without oxygen. The same is true for the business. It can survive a surprisingly long time with low profits, but when its cash runs out, it dies very quickly.

Q: Do you think high accounts receivable are good or bad?

It depends on the business, how they are used and if the aging and amount match with accounts payable. The business owner must manage the collection and timing of accounts receivable in order to manage his/her cashflow. For more details on aging and matching, see the above section, "Why are we not using an income statement in this methodology?" Accounts receivable can lead the Credit Officer to information about the company's customers. You can learn a lot about the client's market from accounts receivable. Also, if collections are beginning to slow, rising accounts receivable will provide a warning that problems may occur in the future. Using this methodology, the credit will only show trends in the accounts receivable through repeat loans in the Repeat Loan Evaluation form.

Q: What effect does a loan have on the balance sheet?

It increases the cash on the Asset side and increases the loan payable on the Liabilities side.

Exercise: Let's set up the balance sheet from top to bottom (Assets on top and Liabilities / Equity below) and the various columns. To show the effect of the loan, use plus (+) and minus (–) rather than the usual accounting debit and credit.

Refer back to the Water Bottling Inc. example. What would happen if the company wanted to undertake a project with a total cost of $400 to purchase a refrigerator ($200) and inventory ($200)? The loan will be for $300 for 12 months. The reader should try to fill in the following table with the effect of the loan.

Water Bottling Inc.
Balance Sheet as of December 31, 1998

Assets	as of Dec. 31, 1998	plus +	minus -	After disbursement
Cash	$ 150			
Accounts Receivable	$ 50			
Inventory	$ 300			
Current Assets	*$ 500*			
Investments in subsidiaries	$ 200			
Net equipment	$ 500			
Fixed Assets	*$ 700*			
Total	$ 1,200			
Liabilities and Shareholders Equity				
Accounts Payable	$ 100			
Taxes Payable	$ 50			
Short-term bank loans	$ 100			
Current Liabilities	*$ 250*			
Long-term bank loans	$ 500			
Long-term Liabilities	*$ 500*			
Equity	$ 450			
Total	$ 1,200			

Answer:
Water Bottling Inc.
Balance Sheet as of December 31, 1998

Assets	as of Dec. 31, 1998	plus +	minus -	After disbursement
Cash	$ 150		$ 100	$ 50
Accounts Receivable	$ 50			$ 50
Inventory	$ 300	$ 200		$ 500
Current Assets	*$ 500*			*$ 600*
Investments in subsidiaries	$ 200			$ 200
Net equipment	$ 500	$ 200		$ 700
Fixed Assets	*$ 700*			*$ 900*
Total	$ 1,200			$ 1,500
Liabilities and Shareholders Equity				
Accounts Payable	$ 100			$ 100
Taxes Payable	$ 50			$ 50
Short-term bank loans	$ 100	$ 300		$ 400
Current Liabilities	*$ 250*			*$ 550*
Long-term bank loans	$ 500			$ 500
Long-term Liabilities	*$ 500*			*$ 500*
Equity	$ 450			$ 450
Total	$ 1,200			$ 1,500

Thus, the loan increases both the liabilities/equity and assets by $300 (total $1200 + $300 = $1500 for both assets and liabilities/equity). In this case, the project costs $400. Short-term loans (under 12 months) increases by $300 and cash decreases by $100, giving the company $400 to spend on the increase in inventory of $200 and net equipment of $200.

Q: What are some tips for collecting the information on a Balance Sheet?

There are many tricks to the trade in terms of how a lender collects information during the analysis process.

First lesson: Never ask a 'closed' question like "This is your entire inventory, isn't it?" Instead, the Credit Officer needs to get the client moving and talking by asking, "Where do you keep your additional inventory?"

Second lesson: The Credit Officer should always verify everything the client or another referee says. This does not demonstrate a lack of trust. It ensures that everything is correct. It is your word and job on the line.

For the balance sheet, some of the following are suggested.

1. **Cash:** The Credit Officer needs to ask about cash in the business, pocket, at home, held with a spouse, etc. Then, the Credit Officer needs to physically verify and count the cash. Although this can be rather uncomfortable, only the verified (counted by hand) amount can be recorded in the balance sheet.
2. **Current Accounts:** The Credit Officer should make the client understand that having bank accounts is viewed positively by the MFI and that the more they have the better. In this way, hopefully the client will bring forth all account statements. The balance of these would be used for the total current account amount. Account statements are also a very good clue into the household's and business's cashflow (if they use the accounts). The Credit Officer should look for clues. A deposit of the same amount on the same day each month could be an alternative source of income. Daily deposits could be sales deposits from the business each day and a good indication of the level of sales. Withdrawals on the same day each month could be another loan payment.
3. **Savings:** Savings are usually obtained and verified through a bank statement. They are very important, as they indicate a level of security the client has in case of an emergency. Instead of not repaying a loan, a client can delve into their savings for funerals, weddings and such.
4. **Accounts Receivable:** Usually clients have manual records of credit given to customers. If they do not, the Credit Officer can help them to create a record, as business owners rarely forget who owes them money. The record would include the date of transaction, name of person, item and amount owed. It would usually be put in age order with the newest at the top and oldest at the bottom. They can be organised according to the more easily collectable and least risky, to the less likely collectable and more risky. The Credit Officer needs to evaluate if these can actually be collected by verifying the receivable with the customer of the client. If the amounts are very small, the Credit Officer may just want to interview 2 or 3 credit customers to verify the list. Then s/he can include all receivables less than 30 days old on the balance sheet. If the receivables are larger and/or the business relies on receivables for much of its business, the Credit Officer will need to pick 10–20% of the items. S/he should pick various sorts of customers and various sizes of receivables (usually, the 3 largest should always be included) and verify these with the customer in person. Then, only those receivables that are collectable and not too old would be tallied. See the discussion above under section "Why are we not using an income statement in this methodology?", for more details
5. **Prepayments**: Sometimes a company will prepay an item. For instance if they pay for raw

materials before delivery and in cash, they will receive a 5% discount. These items need to be checked through receipts and the vendor.

6. **Raw Materials and Inventory:** See discussion on this topic in session 4 under question: How is the inventory information and figures collected and verified?
7. **Moveable and Fixed assets:** The Credit Officer should note the brand, serial number and capacity of all the assets in the business. If possible, they should verify ownership through receipts, vendor or title of these. If there is any doubt about the client owning a certain piece of equipment, the Credit Officer can ask the client to show him/her how the equipment or asset is used. Sometimes the client does not know how and is caught with a piece of equipment he does not own. Finally, the value assigned should be current market value by obtaining at least 3 comparable prices in the market for the same items.
8. **Accounts Payable**: Many clients do not tell the truth about credit from his/her suppliers, as they think it will disqualify them from a loan. So the Credit Officer needs to be a bit sly about the way they obtain this information. They first want to have the client list all of their suppliers and what is purchased from them. Then the Credit Officer should ask to see receipts from the suppliers, which will indicate credit or cash sales. Even if everything looks fine, the Credit Officer should visit the largest suppliers and ask them if the client is a good payer and how they pay (cash or credit). Verify the client's story. Lastly, ALL payables are always included on the balance sheet. See the discussion above under section, "Why are we not using an income statement in this methodology?" for more details.
9. **Other payables:** Check to see if there are any other payables outstanding. Does the business have receipts for taxes for the shop and employees, updated licenses and registration, and any other items relevant to your country and environment? Check to see that these are reasonable for the size of shop, sales level and number of employees. If they are paying less through unconventional ways, there is a risk of being penalized for large sums if caught. This needs to be disclosed to the Credit Committee, if the client is only paying 50% of the expected taxes, for example.
10. **Loans**: The Credit Officer should make the client understand that having other loans from money lenders, MFIs or banks is viewed positively by the MFI. Thus, the client should feel free to talk about their loans. These need to be verified by contracts, repayment receipts and account statements. If they cannot be verified, the client may be delinquent. In the case of a credit bureau, the Credit Officer can check this. More often than not, there is no credit bureau. Then, the Credit Officer must use other methods of checking, such as searching through black lists exchanged by MFIs, or calling a friend who works at the other MFI. Lastly, it is not always the case that a client will be denied a loan from an MFI because they have a loan with another financial institution. If it is a good client, your MFI may want to consider refinancing the other loan and bringing it all under one roof so that you can more easily control the loan and have all the client's business and loyalty.
11. **Equity**: (Sometimes called Shareholder's Capital) Equity is made up of owner investments and cumulative profits. As it is difficult to trace the equity of small business, the formula, Assets – Liabilities = Equity, is usually used to derive the amount of equity. See the discussion above in section "Answers to the Water Bottling Company #7", for more information on equity.

Q: What are the two key balance sheet ratios?

The two key ratios that are important for individual lending for microloans are:

1. Debt to Asset Ratio
2. Inventory Turnover Ratio

<u>Details of Ratios:</u>

Debt to Asset Ratio = Total Debt / Total Assets (after disbursement)

Guide: 30-50% maximum (30% for working capital loans and up to 50% for fixed asset loans)

The Debt to Asset Ratio is important because it tells the MFI whether the client has enough assets to cover his/her debts. Essentially, it helps to determine if the client can sell his/her assets and pay his/her debts. This is the worst case scenario. Most MFIs do not want the debt and assets to match. They want a respectable margin of error. See the guide below, for further explanation. For example, if a MFI requires the debt to asset ratio to be 30% or less, essentially the MFI is asking the borrower to ensure their assets can cover their debt more than three times.

Inventory Turnover Ratio = Average Inventory * duration * 30 / Total Cost of Goods Sold for the same duration.

Guide: Maximum of 20 days turnover for trade, 45 days turnover for production & services and 45 days operations cycle for agriculture.

The Inventory Turnover Ratio tells the Credit Officer how many days it takes the client to turn over all inventory one time (on average). The Credit Officer will after some time gain experience and know what to expect for certain types of businesses. It will allow him/her to see if there is too much inventory in the business and know the risks associated with giving a loan for more inventory. For example, a pet shop wants a loan for inventory and their inventory turnover is 50 days. There is something wrong, as this is a trade business and inventory turnover should be 20 days or less. In this case, the Credit Officer rechecks all their figures for inventory and cost of goods sold and recalculates the ratio to make sure it is not a calculation error. If these items are correct, then the Credit Officer needs to re-evaluate. The Credit Officer may want to talk to the borrower about trying to get goods on credit of 60 days from the supplier. Another option would be for the borrower to allow the inventory, which does not turnover well, to deplete and buy more of the inventory that turns over more quickly.

Continue Exercise 6.1 by calculating the two key balance sheet ratios.

Question: What is the Water Bottling Inc.'s Debt to Asset Ratio? Calculate this at the bottom of Exercise 6.1.

Answer: Before loan = ((ST loan 100 + LT loan 500) / Tot Assets 1200) = 50%

After loan = ((ST loan 400 + LT loan 500) / Tot Assets 1200) = 60%

Question: Is this acceptable?

Answer: No. Before the loan, the debt to asset ratio was 50% (100 + 500 / 1200) and after the loan, it would be 60% (400 + 500 / 1500). However, if sales and available cash are both high and sufficient to cover all obligations, the case could be made to substantiate the loan.

Question: Is everything else alright with this client? Except the debt to assets ratio, what is the only way that this business could take a loan?

Answer: The Company has too much debt and needs to pay down some of its current loan(s) or contribute more to get the ratio to decrease. Or, it could prove that it has sufficient free cashflows to adequately cover all obligations.

Question: What is the Water Bottling Inc.'s Inventory Turnover Ratio? Calculate this at the bottom of Exercise 6.1.

Answer: Average Inventory = (start inventory + inventory after disbursement) / 2 = (300 + 500) / 2
Duration = loan term = 12 months
Number of days per month = 30
Total COGS for the loan duration = COGS per month * 12

Inventory Turnover Ratio = 40 days

Question: Is this acceptable?

Answer: 40 days is quite long for a water-bottling trade business. The inventory may be too high for the level of sales. The Credit Officer must consider the type of goods the business trades. If the business trades in fresh fruits, then one week would be too long. If the business deals in large ticket items, such as electronic equipment and motorcycles, then 40 days may be the norm.

Checklist for Reading Balance Sheets

Does the Balance Sheet balance?

Are the accounts receivable reasonable? Aging? Bad debt?

Are the accounts payables reasonable? Aging? Do they pay their suppliers regularly?

Is equity positive?

Did the owner contribute any equity to the business? When?

Check the total debt to assets ratio. More than 30% for working capital? More than 50% or capital equipment?

Check assets before loan / assets after the loan. If this is more than 50%, it could be a bit risky.

Check the effect the loan has on the inventory. Is the inventory increasing more than 50%? Does the company really need this much inventory?

Inventory Turnover appropriate for the sector: ~ < 20 days trade; ~ < 45 days production; <= the harvest cycle for agriculture? (Shorter turnover may be appropriate for perishable goods such as fresh fruits and vegetables whereas longer turnover may be appropriate for larger ticket items such as cars)

Accounts Receivable Turnover should not be more than the business' Accounts Payable payment terms for their clients.

Is the cash amount reasonable? Does it match the cash in the cash flow? How was it verified?

Are the fixed assets valued at a reasonable price using comparative evaluation method?

Does the client have any other debts outstanding? How was this verified?

Red Flags:

⚐ Check the cash level. The business should have enough to cover daily needs and little emergencies. Low cash could mean a crisis for the client.

⚐ Be aware of clients with high accounts receivable, high accounts payable, an imbalance between short-term assets and short-term liabilities, an imbalance between long-term assets and long-term liabilities, low cash or different cash in the balance sheet and cashflow, and negative equity. Use the checklist to aid in this process.

⚐ Schedules of aging of accounts receivable and payable can give many clues about the business to the Credit Officer. Verify both receivables and payables. Make sure that there is no bad debt or that uncollectible receivables are left off the balance sheet.

⚐ Be aware of tax liabilities reported and not reported, as these can come back to haunt clients.

⚐ Make sure that the client is reporting all other debt by thoroughly verifying and checking all sources.

⚐ Make sure your ratios are correctly calculated before jumping to conclusions.

⚐ If the inventory turnover ratio is too high, explore alternatives, but do not just go ahead with a loan if inventory will sit for extended periods of time. Evaluate the business and loan purpose very carefully and talk to the client.

⚐ Verify facts and figures from a 360 degree view – client, suppliers, customers, employees, relatives, local officials, etc.

Session 7: Collateral

Q: What is collateral and why do MFIs need it?

Collateral is defined as an "asset pledged by a borrower to a lender until a loan is paid back. If the borrower defaults, then the lender has the right to seize the collateral and sell it to pay off the loan." (Balkenhol, 2002)

Credit Officers should ensure that the collateral taken from the borrower:

1. Shows the commitment of the borrower to repay.
2. Increases the pressure on the borrower to repay.
3. Is a secondary source of repayment if the borrower fails to meet the payment schedule.

It is the responsibility of the Credit Officer to work with the customer to identify collateral or collateral substitutes that fit within the MFI's collateral policies and procedures. The Credit Officer should simply follow policy for collateral: take the necessary and correct types, personally verify that it exists and is in good working condition, value and register it. In most cases, it is the Credit Officer who values the collateral, although sometimes MFIs may have a separate valuer to aid in this process.

Five things differentiate individual loans from group guaranteed loans: individual loans are to one person, are larger, require cashflow analysis for repayment capacity, require larger amounts of COLLATERAL, covered in this section, and monitoring.

Collateral is also one of the 5 C's of lending: Capacity to repay (or Cashflow), Capital, Character, Conditions and Collateral. The trainer should explain that although collateral is one of the 5 C's of lending, cashflow analysis and the ability to manage the business are far more important than collateral in individual lending.

Although it is a very important component of Individual Lending and the loan analysis process that the Credit Officer undertakes, collateral should not be the only basis for making a loan decision, either rejection or approval. If the borrower passes all the other eligibility and loan analysis criteria, then collateral should not stop the MFI from making the loan. On the other hand, a loan should not be given on the basis of collateral alone. It should be the policy of the MFI to evaluate the merit of a loan, based on commercial viability, and the commitment and character of the borrower. Loan decisions should NOT be based solely on collateral.

Q: What influences MFIs' collateral policy and requirements?

Take the class expeditiously through the nine influencing factors. Remember that the Credit Officers need to review these and understand why and how collateral policies are made. Although they will not be setting policies, they will be impacting policies by giving suggestions from the field. Go through the slides on this.
There are nine factors that a MFI should consider when designing its security and collateral policies. These factors are interdependent on one another in designing the right policies. They are also particular to the institutions and country in which they operate.

Influencing Factors: (Churchill, 1999)

1. Institutional mission: Many institutions do not allow collateral to become a deal breaker if the client is credit worthy in every other sense. The institution will find other methods of securing the loan, such as through third parties. It can reduce risk by reducing the loan size,

loan term, frequency of repayments, and/or nature of repayments (e.g. through automatic deductions).

2. Loan size: Smaller loans rely more heavily on collateral substitutes and informal or unregistered collateral. The larger a loan, the more the MFI should expect to use registered assets and fixed assets as collateral. Loan size is usually the most significant determining factor for collateral requirements in most MFIs and banks.

Example of how loan size influences a MFI's policy.

Alexandria Business Association (ABA) Loan Eligibility Requirements[1]

Loan size ($)	*Requirements*
< 900	Personal ID card; fixed business address
> 900	Ability to read and write; business license
1,500	Certificate indicating workers are covered under the social security system
2,200	Tax card indicating that they are complying with business tax laws
3,000	Checking account
4,500	Financial statements for the business

With each increased level of loan size, the ABA requires confirmation that the business is in compliance with all the local laws.

(Churchill, 1999)

This example does not, literally, include collateral criteria. It makes the point that it is easier for the MFI to take the borrower to court and confiscate collateral, if the business is more formalized. For example, if a business is registered and complies with all the government regulations, it is easier to take legal action against it. This assumes that regulations are enforced. When regulations are not enforced, or when they are enforced very slowly, this causes the MFI great expense and effort. The usefulness of a policy of more formal collateral with larger loans loses it potency without proper government enforcement.

1. Income level of clients: Many MFIs give lower income clients a break by requiring less collateral / less formal collateral in hopes of giving lower income clients a fair chance of obtaining access to larger loans.
2. Type of business: The type of business can influence the type of collateral required by the MFI. For example, clients with fixed business addresses, as would be the case with most Individual Lending clients, could be allowed to pledge non-perishable business assets other than fixed assets (i.e. equipment, inventory, vehicles, etc.) and household assets.
3. Type of loan: Fixed assets purchased with the loan can be used as collateral. In many countries, such as Kenya, the MFI can retain official ownership of the equipment until the loan is fully repaid making ownership issues and confiscation easier.
4. Registration of the business: If a business is registered, it is easier to take legal action against the client in the event of default.
5. Legal environment: The availability of collateral registration and ability to efficiently (time and cost) enforce contracts is country-specific. In many countries, MFIs use post dated cheques to ensure repayment (post dated cheques are explained below). It is pertinent that MFIs understand the legal environment, work within it and understand what laws may actually aid or limit the MFI before setting policy. Every country is different. The MFI must determine the best method for their legal environment.

[1] Churchill, Client Focused Lending, page 31.

Ugandan regulatory system aids the MFIs:

In Uganda, a person who bounces a check is arrested. This makes it easy for the MFI to find the client and to demand repayment. It also is a good psychological deterrent for the client.

1. Land Tenure systems: In countries where land ownership is common and clear and title liens are easily obtainable, traditional collateral (i.e., land) is most effective in securing loans. Gender constraints can be an impediment to lending in societies where husbands own the land.

2. Character/Status of the Borrower: Where the borrower has a strong image in the community, collateral may play a less significant role, as there are substitutes. Social exposure and pressure play a large role in this as well.

These factors will be examined in more detail in the Credit Managers' Individual Lending Toolkit.

Q: What are the various types of collateral?

In commercial banking, land and property titles are almost exclusively used for collateral and largely determine a borrower's access to loan capital. MFIs have eased the collateral requirements by developing original approaches to allow traditionally unbankable clients financial access to larger, individual loans.

MFIs now accept many different forms of collateral besides property/fixed assets, such as personal guarantees, third party guarantees, chattel, post dated cheques, equipment (pasta producing machine, mechanical car lift, sewing machine, etc.), and vehicles. These other types of collateral, called collateral substitutes or non-traditional collateral, are pledges of assets or guarantees that either take the place of traditional collateral or are used in combination with traditional collateral.

Throughout the MF industry, various types of collateral are used with the Individual Lending product. Collateral and collateral substitutes are not used exclusively. Many MFIs will allow several types of collateral to guarantee their loans, thus diversifying the possible repayment methods they can utilize as well as allowing more borrowers access to larger loans.

Types of Collateral and Collateral Substitutes used for Individual Lending
1. Personal guarantees 2. Third party guarantees 3. Chattel 4. Gold 5. Savings 6. Post dated cheques 7. Business Assets 8. Vehicles 9. Mortgage of Real Estate / Fixed assets

Details of types of Collateral and Collateral Substitutes:

1. **Personal guarantee**s used in combination with other forms of collateral: commitment from the borrower and others who understand that they are personally responsible for the repayment of the loan. Most MFIs require at least two personal guarantors to sign the loan documentation. The purpose of these guarantees is to tie the owners and managers to the destiny of the company. In many cases, the shareholders and managers do not have adequate personal assets to repay the loan. However, by signing the personal guarantee, they make a personal commitment to ensure the company repays the loan. Influential personal guarantors have proven to be very useful to influence clients to repay and on some occasions the personal guarantors have actually repaid for the client. It is recommended that a personal guarantee is signed by all the owners/shareholders of a business and their spouses. MFIs must be careful

as often guarantors can get overburdened, guaranteeing many loans at the same MFI and/or multiple MFIs.

2. **Third party guarantees**: the guarantee is normally an affiliated business, a relative or close friend. Due diligence on this form of collateral requires an analysis of the character and financial situation of the guarantor. A guarantee is often not a good substitute for other, more tangible assets, since it requires a more detailed analysis and may provide a false sense of security. In addition, the guarantor often requires the borrower to pay some kind of fee for the guarantee and this makes the loan more expensive and therefore, more risky. A better scenario under third party guarantee is one in which the third party guarantor actually pledges a physical asset and/or salary that can be legally registered and collected upon. In some countries where the economy is depressed, there are only a few people with steady jobs or income sources, and these individuals are asked to be guarantors to many potential borrowers (Bosnia and Newly Independent States for example).
3. **Chattel**: Moveable personal property used for securitization on smaller loans or as additional collateral on larger loans. Chattel may not be worth much to the MFI, but can serve as psychological security as some personal belongings are worth more to the client than their resale value.

MFIs need to check the laws in their particular country because some personal property is not acceptable to be taken as chattel, such as beds in Uganda.

4. **Gold**: In some societies possession of large quantities of gold jewellery is common. MFIs can weigh and vault the gold as a form of collateral. The MFI usually assigns a lower than market rate per gram and does not consider the workmanship of the piece nor the gemstones in the piece. Since gold is highly valued in these countries it is easy to resell. Also, the gold jewellery usually has a high psychological value. Drawbacks of gold are the internal controls required and physical vault needed to house the jewellery.
5. **Savings**: MFIs may use liens on savings accounts to guarantee loans. The savings can be of the borrower or a third party and are frozen until complete repayment of the loan. The authority to debit an account without the borrower's permission should be part of this agreement. Also, savings within the MFI can be an additional required guarantee. For example, some institutions require 20% of the loan amount to be deposited in a savings account and frozen before disbursement of the loan, in addition to full collateral coverage by other means. Other institutions may require the client to hold a deposit equal to one loan instalment with the MFI which may not be as onerous as 20% of the loan amount. Required savings can be counterproductive to the borrower's reinvestment and profits in their business. The requirement of savings in addition to collateral can significantly increase the effective cost of the loan to the borrower. Some institutions have voluntary savings that are used as collateral. In reality, it is not voluntary. It should be labelled as cash security, a deposit for the loan, or savings towards a loan.
6. **Post-dated cheques:** Cheques filled out by the borrower for the amount of the repayment with the future date of the repayment that can be deposited in case of late or non-payment against the borrower's account. In many MFIs, the client must obtain a checking account within the MFI or at an outside bank. Upon disbursement of the loan, the client writes one check for each repayment scheduled, filling in the post date, MFI's name and amount before signing the check. The MFI only uses the post-dated check in the case where the client is late in repaying. This method is very quick and convenient; however cheques may not be prevalent in some countries.

Post-dated cheques should not be used as a regular method of payment. It is better for the client to get used to paying and for the Credit Officer to follow up on delinquencies with the client face to face. The client could have a problem and the Credit Officer would not know about it.

7. **Business Assets:** Usually assets consist of equipment, furniture, fixtures, vehicles and inventory. In most cases, the borrower retains possession for business operations. A pledge form is signed by the MFI and borrower, precisely identifying the collateral pledged by name, brand and serial

number. In some cases, the equipment is assigned to the MFI's name for ease of collection and until the loan is repaid. Equipment is movable and lacks surety of repayment, but eases the cost and time burden on the client and MFI. To reduce risk, this form of collateral can be used in conjunction with other forms, such as a deposit or post dated cheques. If insurance is reasonable, it should be required throughout the loan repayment terms. Inventory for trade loans (especially wholesalers) can be taken as collateral valued at the lowest level of inventory.

8. **Vehicles**: Any type of vehicle owned by either the borrower or business. Many MFIs use vehicles as a form of security for individual loans as they usually have a higher asset value than non-traditional assets, are more difficult to hide, and are easier to secure in some countries. Many MFIs retain and vault the vehicle's log book and pre-signed transfer of title during the loan repayment. Sometimes insurance of the vehicle is required throughout the loan repayment which increases the effective interest rate.

As vehicles are moveable property and potentially could be crashed and/or stolen, it would be prudent to require an insurance policy in the amount of the loan plus interest (if it can be obtained for a reasonable price).

9. **Mortgage of Real Estate / Fixed Assets**: This is the preferred collateral for larger loans because it is subject to registration and has higher value than other forms of collateral to cover larger loans. Although land and property provides more security, the cost and time needed for registration are in many cases excessive for the client. In addition, the judicial proceedings in the event of non-payment are very costly and time consuming, ranging from a few months to years, depending on the country. Another form of this, but less legitimate is where the borrower does not have a registered title, due to lack of land tenure systems in a country. Although it is not officially legitimate, some MFIs take land as collateral through an agreement signed by the borrower and village chief, local commissioner or higher official without formal registration (called kibanja in Uganda). If the loan goes into default, the village chief or official aids in the arbitration and sale process. Although this method is not always successful, it is far less costly and time consuming for the client upfront and for the MFI in case of default.

Insurance could also be required in case of damage, fire or flood for real estate if it can be obtained for a reasonable amount. In the Caucasus, ShoreBank arranged for borrower discounts to purchase insurance (vehicle, property and life) and obtain notary services.

Generally items can be classified in the following manner:

Collateral	Collateral Substitutes
Gold Savings Business Assets Vehicles Mortgage of Real Estate / Fixed assets	Personal guarantees Third party guarantees Chattel Post dated cheques (Group lending - peer pressure also here)

Q: What are the characteristics of collateral versus collateral substitutes?

Generally, collateral and collateral substitutes can be characterized by the following table:

	Collateral	Collateral Substitutes
Transaction cost	High	Low
Registration time	High	Low
Legality	High	Low
Resale value	High	Low
Resale Market (time to sell)	High	Low
Psychological value	High	Can be both high and low
Likelihood to be used for Larger loans	High	High
Likelihood to be used for Smaller loans	Can be both high and low	High

From this table, you can see that most institutions would want collateral, rather than collateral substitutes, and most borrowers would want to give collateral substitutes. There must be a compromise.

Q: So why should MFIs bother with collateral substitutes?

Collateral substitutes are easier for the borrower to pledge and for the MFI to take. The process is less costly, quicker, and can have high psychological value to the client. They are usually used in combination with other pledged collateral items for larger individual loans.

Psychological value is extremely important in enforcing repayment, but not easy to measure. The psychological value of particular items differs widely from client to client. The Credit Officer must understand what drives his/her culture and each client. This is an important point for the Credit Officer to understand and learn through experience.

Requiring only traditional collateral can significantly increase the costs of the loan to the borrower and consume a considerable time period to undertake the registration. In many instances, registering collateral can delay the loan disbursement by many days or even months.

MFIs who take traditional collateral for individual loans rely on its legality, resale value and psychological value, but sometimes do not factor in the expense to the client as part of the transaction cost, time to register the collateral as lost interest income, and the future potential high cost of repossessing the collateral. MFIs should consider the collateral transaction costs as a part of the effective interest rate. MFIs and Credit Officers must strike a balance between the amount/type of collateral required and the benefits / risks to the MFI. Every effort should be made by the MFI to make collateral a secondary requirement to receiving a loan, as least costly as possible without sacrificing the security of the loan, and expedite the process as much as possible. To do this, the MFIs and Credit Officers should use a combination of collateral and collateral substitutes that can cover the loan, but not overburden the borrower.

Q: What are some of the possible combinations of collateral and collateral substitutes a MFI / Credit Officer can take?

The trainer should explain that the possibilities are endless. In most cases, MFIs require a combination of collateral and collateral substitutes to secure a loan. A MFI can use any combination of the nine types of collateral and collateral substitutes in securing loans. Here are some examples from the field:

At Cajas Municipales de Ahorros Y Creditos, influenced by Internationale Projekt Consult GmbH (IPC), three types of collateral are used:

1) Client savings,
2) Fixed and moveable assets, and
3) Co-signers, who guarantee loans with their regular salaries. In this case, the value of the collateral must be 150% of the loan.

A MFI in East Africa uses many different types of collateral in combination:

Required for all loans:
1) Post dated cheques,
2) Spousal guarantee, and
3) Collateral that must have high psychological value.

Plus other collateral:
1) Chattel items only (shall cover at least 100% of loan);
2) Guarantor (in addition to spousal), plus chattel items that cover at least 75% of the loan); OR
3) Real estate, plus chattel items and/or guarantor (chattel items shall cover at least 50% of loan).

* Inventory can be substituted for any items up to 50% of loan.

There are two points of view in this equation, the lender's and the borrower's. From a lender's point of view, collateral should be marketable, easy to collect from the client and have a low transaction cost and time. The borrower wants pledged collateral requiring the least amount of time, transaction cost, impact on the household and enterprise, and social exposure. (Balkenhol, 2002)

Another example of collateral requirements from the Micro Enterprise Bank, Philippines:

Collateral/Security requirement	Loans less than $900 – home appliances Loans > than $900 to $1,800 – vehicles, equip. etc. Loans > than $1,800 – real property
Life Insurance	Borrower will be enrolled in a group life insurance plan equal to the amount of the loan and effective until loan maturity.

It is important to diversify collateral for two reasons:

1) Clients are more easily able to fulfil the collateral requirements if they can pledge a variety of different items giving financial access to a wider target group and

2) MFIs may run into road blocks collecting on certain items, so they can attempt to collect on other items from the same borrower.

Q: Who appraises the collateral and collateral substitutes and how is the evaluation completed?

The appraiser in a MFI is often the Credit Officer who underwrites the loan. This is time and cost efficient, but does not always produce the best valuations, as the Credit Officer is often not properly trained. Alternatives to having the Credit Officer serve as the appraiser are having another Credit Officer; an external, contracted, qualified appraiser; or in busy offices, an internal qualified appraiser can be justified. These alternative methods also serve as an internal control to keep the valuation more objective.

Shore Overseas Azerbaijan uses an external real estate agent, who is a certified appraiser to evaluate real estate. Most of their loans are secured by real estate. The market environment necessitates that the appraiser understands and knows the current market conditions. In Azerbaijan, real estate transactions are not public knowledge. Thus, an appraiser, who is also a real estate agent, knows the actual prices of recent real estate transactions and understands the market and resale potential.

Valuation is not exact and can be very subjective. Remind the Credit Officers that they need to be able to backup their evaluation with some real market values and logic. MFIs should use comparison data and not just the Credit Officer’s opinion to evaluate collateral.

For real estate, equipment or a vehicle, the appraiser should complete a Comparison Evaluation Form for the appropriate collateral. See Handouts #7.1: Comparison Evaluation Form for Real Estate, #7.2: Comparison Evaluation Form for Equipment and #7.3: Comparison Evaluation Form for Vehicles.

7.1 Collateral Evaluation Form for Real Estate					
	Property to be collateralized	**Adjust ment 1**	**Comparison Property 1**	**Adjust ment 2**	**Comparison Property 2**
Client name			Source of data:		Source of data:
Date of visit			if visited:		if visited:
Documented Owner's Name			if known:		if known:
Documented Owner's Relation to Client					
Marital Status of Registered Owner (married, not married, separated, divorced) (need signature of spouse)					
Type of property ownership (business, private)					
Type of Premises (apt, house, retail shop, factory, warehouse, office)					
Address of property					
# of floors					
Floor #					
# of rooms					
Overall size (sqm)					
Year structure built					
Condition (renovated, partially renovated, no renovation):					
Registered properly with new construction and renovations included?					
Certificate of ownership/Title (available, not avail, other):					
Evaluator's Description of Property					
Evaluator's estimated market value					
Liquidation %					
Forced Sale Value					
Evaluator's Final Comments on Assessment and/or Property (for comparison property this should be a description of the reasons why this property is better or worse than the client's property and the actual deductions and additions in costs)					
Evaluator's Name					
Evaluator's Title and Organization					
Evaluator's Signature					
Date					

7.2 Collateral Evaluation Form for Equipment					
	Equipment to be collateralized	**Adjusted 1**	**Comparison Equipment 1**	**Adjusted 2**	**Comparison Equipment 2**
Client's name			Source of data:		Source of data:
Date of visit			if visited:		if visited:
Documented Owner's Name			if known:		if known:
Documented Owner's Relation to Client					
Marital Status of Registered Owner (married, not married, separated, divorced) (need signature of spouse)					
Type of equipment					
Brand					
Serial #					
Production year					
Odometer Reading (km) (if applicable)					
# of previous owners (if known)					
Colour					
Condition (Good, fair, poor)					
Evaluator's Description					
Evaluator's estimated market value					
Liquidation %	% source:		% source:		% source:
Forced Sale Value					
Evaluator's Final Comments on Assessment and/or Vehicle (for comparison equipment this should be a description of the reasons why this property is better or worse than the client's property and the actual deductions and additions in costs)					
Evaluator's Name					
Evaluator's Title and Organization					
Evaluator's Signature					
Date					

7.3 Collateral Evaluation Form for Vehicle					
	Vehicle to be collateralized	**Adjusted 1**	**Comparison Vehicle 1**	**Adjusted 2**	**Comparison Vehicle 2**
Client name			Source of data:		Source of data:
Date of visit			if visited:		if visited:
Documented Owner's Name			if known:		if known:
Documented Owner's Relation to Client					
Marital Status of Registered Owner (married, not married, separated, divorced) (need signature of spouse)					
Plate #					
Chassis #					
Engine #					
Type of vehicle					
Production year					
Odometer Reading (km)					
# of previous owners					
Colour					
Condition (Good, fair, poor)					
Evaluator's Description of Vehicle					
Evaluator's estimated market value					
Liquidation %	%				
Forced Sale Value					
Evaluator's Final Comments on Assessment and/or Vehicle (for comparison vehicle this should be a description of the reasons why this property is better or worse than the client's property and the actual deductions and additions in costs)					
Evaluator's Name					
Evaluator's Title and Organization					
Evaluator's Signature					
Date					

Detailed steps for the Appraiser to complete the forms are:

1. Complete the first column for the borrower's pledged collateral with all details.
2. Identify two other like items being sold on the market, called "comparative items".
3. Obtain real, up-to-date, comparative data and prices for these similar items.

> This should include real sale prices that the Credit Officer has verified in person, not just a quote out of the newspaper or from an advertisement, as sale prices are usually different from their advertised price.

4. Complete Comparison 1 and Comparison 2 columns with the detailed data and price. Once again, review comparative items to ensure similarity to the pledged item.
5. Compare the pledged item to Comparison 1 and circle the differences. For example, if the pledged car is a 1990 model, and the comparative item is a 1991 model, circle 1991.
6. Identify how each different item will affect the price of the pledged item, and subtract or add the monetary value in the Adjustment 1 column. For example, if the pledged car is a 1990

model and the comparative car is a 1991 model, enter -$800 in the Adjustment 1 column next to the year.

7. Continue to do this for each line item that is different from the pledged item.
8. When complete, add all the adjustments to the sale price and calculate the adjusted sale price. For example, if the year was the only difference between the pledged car and comparative 1 car, and the sales price of the comparative 1 car was $5000, then the comparative 1 adjusted sale price would be $4200.
9. Repeat steps 3 through 8 for comparative item 2.
10. After obtaining the final adjusted sales prices for both comparative items, take an average. This is the market value of the pledged item. Make sure that this price makes sense in the market and that one of the comparative values is not very low or high, skewing the evaluation.
11. Finally, adjust the pledged item market value down by some percentage to obtain the liquidation or forced sale value (10-50%) in case of default. More details on valuation are provided below.

These same steps are preformed for Real Estate, Equipment and Vehicles.

Many clients may pledge the same types of collateral. In this case, if comparative data has already been identified previously, the appraiser can use this information for multiple borrowers' collateral valuation assuming it is within a reasonable time period. The MFI should set an expiration date for the comparative data. For most markets, 3 months for property and 1 month for vehicles and equipment would be reasonable.

The chattel appraisal method assumes that many borrowers pledge the same type of items (i.e. refrigerator, television, radio, etc.). Thus, every month or two, according to the MFI's policy, the appraiser collects the comparative data, fills in the Comparison Evaluation Form for Chattel and copies it for the Credit Officer's reference. See sample of completed form below.

Chattel Valuation (this is an average of 3 quotes from used furniture/appliance shops)

Date Completed: 10-May-04
Date Expires: 9-Nov-04

	Item	years old	Condition	Used Products, Bombo Rd #2		Appliance World, Nassar Rd #56		Almost New, Entebbe Rd #45		
				Sale Value	Forced Sale	Sale Value	Forced Sale	Sale Value	Forced Sale	Average Forced Sale
1	two seat sofa	8 - 10	fair	50,000	35,000	45,000	31,500	41,000	28,700	**31,733**
2	large chair	6 - 9	good	40,000	28,000	38,000	26,600	34,000	23,800	**26,133**
3	coffee table wood 70x30cm	3 - 4	fair	40,000	28,000	40,000	20,000	36,000	18,000	**22,000**
4	side table wood 30x20 cm	3 - 4	fair	20,000	14,000	15,000	7,500	11,000	5,500	**9,000**
5	refrigerator w/ freezer - large	9 - 12	good	100,000	70,000	80,000	56,000	76,000	53,200	**59,733**
6	gas cooker 2 burners	3 - 4	good	45,000	30,000	40,000	28,000	36,000	25,200	**27,733**
7										
8										
9										
10										

MFIs' policies should be very clear, explaining the valuation method to be used and the liquidation (or forced sale) percentage of the market value to be used for most items.

ShoreBank's Developing Enterprise Loan Policy for Collateral Liquidation Valuation in the Republic of Georgia:

Collateral market value is based on a comparison of at least 3 items. Below are the approximate liquidation (or forced sale) values for common items:

1. Real estate with a residential house ~ 80%
2. Real estate with a business building ~ 80%
3. Property without a building ~ 60%
4. Vehicles ~ 80%
5. Equipment (business) ~ 50 - 80%
6. Household furniture and equipment = 50 - 80%
7. Gold ~ 80%

Liquidation values depend on the condition, location, and item. If the item is in high demand, such as a second floor apartment in a prestigious area of town, the liquidation value would be 80%. If the apartment is in a less prestigious area and harder to sell quickly, the liquidation value might drop to 70%. The liquidation values for equipment and household goods vary widely, as some items are unique and have very limited resale potential.

Q: So now we know what collateral is, how to evaluate it and calculate the liquidation value; how much collateral is required?

The amount of collateral required varies widely from country to country and MFI to MFI. First, there are varying policies on what type of collateral is required (discussed above) for different types of loans. The usual scenario is that the larger the loan, the more formal collateral is required. For example, land titles are required as collateral for larger individual loans, and equipment and/or vehicles are required for smaller individual loans.

Secondly, some MFIs are more conservative than others. They may use low liquidation percentages and require large amounts of collateral. Most MFIs have a collateral coverage policy that is similar to the following:

Loan to Value < 75%: This value (loan amount / total liquidation value of the collateral) is less than or equal to 75%. In other words the loan amount can only be a value of 75% or less than the forced sale value of all the collateral combined.

Another way to state this is **Value to Loan > 130%**, which means that the total liquidation value of the collateral / loan amount is greater than or equal to 130%. In other words the forced sale value of all the collateral combined must be at least 30% greater than the loan amount.

It is prudent to take guarantees from spouses always.

Additionally, some MFIs require insurance for the collateralized items and life insurance for their clients. In many cases the life insurance is covered by the MFI.

Review the table from *Exercise 5.1 Case Study Grocery* in *Session 5* to show the class how the collateral is scheduled and tallied.

Item	**Acquisition Cost**	**Date**	**Market Value**	**Liquidation %**	**Liquidation Value**
1. Shop Building	4,650	1999	3,000	50%	1,500
2. Owner's house (3 rooms)	1,800	1988	2,500	50%	1,250
3. Personal guarantee from owner(s) of the business.					
TOTAL LIQUIDATION VALUE					**2,750**
Total Liquidation Value / Total Loan Value					**138%**

Collateral Example: Collateral requirements for a Ugandan Bank disbursing small loans:

All clients have to have:

1. Real estate - land with a building with at least the roof completed. The land and building should cover at least 150% of the loan by itself or 100% with equipment covering the remaining 50%
2. Equipment - if owned, covering up to 50% of the loan
3. Guarantors - with a verified regular salary history and assets to cover the loan
4. A spousal guarantee – required for all loans
5. Insurance is required to cover all property up to the loan plus interest value
6. Life insurance is required for all clients

The bank's required total collateral value (real estate + equipment) to loan value is greater than or equal to 150%. The liquidation value of the real estate is taken at 50%. Also, the internal appraiser tends to undervalue collateral to be sure that he has enough in case of default.

Collateral case:

A client owned a house that was recently purchased for $12,000, was valued by the Credit Officer at $9,000, and had a liquidation value calculated as $4,500. The client applied for a loan of $4,000, but did not have enough collateral (4500/4000 = 113%) to cover the bank's requirements.

In the case above, the Credit Officer tended to undervalue the collateral and take too much from the client, just to make sure he was covered. In this case, the borrower had to pay higher registration costs due to having to pledge additional collateral in order to secure and cover the loan. The Credit Officer took a risk in valuing the collateral so low. The client could have withdrawn his/her application because of these higher costs. For example, in the Grocery Store Case Study, if the Loan Officer had valued the building at $4,000 market value with a 75% liquidation value, this one property could have sufficed as collateral. Instead, the Credit Officer undervalued both properties and caused the client to register two property titles, which was almost twice as expensive.

In most cases, the opposite is usually true. The Credit Officer overstates the collateral values to enable a larger loan amount to be approved. In this case, the MFI runs the risk of not being able to recover the full amount of the outstanding loan balance if they have to go to court to recover the funds. Plus, if the whole portfolio is made up of under-collateralized loans, this is very risky in the event of a major default by multiple borrowers. MFIs and managers need to be careful and check the collateral valuation periodically. An external appraiser should do random checks, the internal auditor should follow up on questionable items and managers should do their own random checks.

In both cases, there are risks and costs that are unwarranted.

Shore Overseas Azerbaijan Collateral Policy:

It is the policy of Shore Overseas Azerbaijan to evaluate the merit of loans based on commercial viability and the commitment and character of the borrower. Loan decisions are NOT based on the basis of collateral or guarantees. It is the responsibility of the Loan Officer to work with the customer and identify collateral or collateral substitutes that:

1. Show the commitment of the borrower to repay.
2. Increase the pressure on the borrower to repay.
3. Provides a secondary source of repayment if the borrower fails to meet the payment schedule.

For Small Business loans, the following types of collateral and substitutes are acceptable:

Pledge of Physical Assets
This usually consists of equipment, furniture, fixtures, vehicles and inventory. In most cases, the borrower retains possession for business operations. A pledge form (with attached schedule) signed by Shore Overseas Azerbaijan and the borrower precisely identifies the collateral pledged by name, brand and serial number. Identification of collateral by general name (e.g. “bread-making equipment”) or by address (e.g. “the equipment located at Big Street”) is NOT adequate. A second attachment for equipment purchased with loan proceeds will be added after purchase.

This may also include personal assets of the borrower that are kept in his/her home.

A Lien on a Savings Account
Funds could be those of the borrower or a third party. The authority to debit an account without the borrower’s permission should be part of this agreement.

Third Party Guarantee
The guarantee is usually by a third party, which is normally an affiliated business, a relative or close friend. Due diligence on this form of collateral requires an analysis of the character and financial situation of the guarantor. A guarantee is often not a good substitute for other, more tangible assets, since it requires more detailed analysis and may provide a false sense of security. In addition, the guarantor often requires the borrower to pay some kind of fee for the guarantee and this makes the loan more expensive and therefore, more risky.

Personal Guarantees – in addition to another form of collateral
Unless there are exceptional reasons in any particular case, it is a policy of Shore Overseas Azerbaijan to get personal guarantees signed by all the shareholders of a borrower. The purpose of these guarantees is to tie the owners and managers to the destiny of the company. In many cases, the shareholders and managers do not have adequate personal assets to repay the loan. However, by signing the personal guarantee, they make a personal commitment to ensure the company repays the loan. Under Azerbaijani law, a sole proprietor should not sign a personal guarantee because he already is personally responsible through his company. Therefore, in the case of a sole proprietorship, a personal guarantee is not signed.

Jewellery or Other Precious Assets
For trade loans, especially for wholesalers, Shore Overseas Azerbaijan can secure these items at a local bank.

Mortgage of Real Estate
Some larger borrowers may own property and this may be pledged against a loan from Shore Overseas Azerbaijan. This is the preferred collateral for SME loans because it is subject to registration, and therefore provides more security to SOA as lender.

Inventory
For trade loans (especially wholesalers), Shore Overseas Azerbaijan will always take inventory as collateral valued at the constant level of inventory. This should generally be considered a secondary security, not as attractive collateral as real estate or gold.

The following type of collateral may be accepted:

- Loans less than $2,000 - equipment (up to 90% of loan value) and gold (at least 10% of loan value)
- Loans equal to or greater than $2,000 - registered collateral is preferred, and the liquidation value should equal at least 80% of total collateral

Additionally, Shore Overseas Azerbaijan will always take personal guarantees, spousal guarantees, and business assets and inventory as security.

(Tjossem, 1999.)

Q: What is perfecting collateral and how is it done?

Perfection of collateral refers to the legal procedure one must follow to insure one's legal rights to collateral and to make one's right to that collateral a matter of public record.

A lien on real estate is perfected by having the borrower sign a mortgage and in some cases having the mortgage notarized, after which the bank records that mortgage in the registrar's office where the title was originally recorded (could be in the place where the real estate is located or in the capital city). A lien on a vehicle is perfected by having the lien holder's name added to the vehicle title or transferred to the lien holder's name. A lien on movable business assets (e.g., furniture, equipment, receivables) is perfected by having the borrower sign a security agreement. A lien on fixtures attached to a piece of real estate (e.g. lighting, shelving, etc.) is perfected by having the borrower sign a security agreement (or including fixture language in the mortgage).

The types of assets one can take as collateral, how and where those liens are perfected (and even whether they can be perfected), whether those liens are publicly disclosed, and the rights a lien holder has, with respect to the collateral vary widely from country to country. In some countries, signing and properly recording a particular document gives you the right to immediately seize anything and everything someone owns, short of their children. In other countries, you can sign and record all the paperwork you want, and it will not get you anything. There are even countries where the entity that registers the last lien on a piece of real estate has the first rights to the property (rather than the first one!).
(Charlene Soby, ShoreBank Chicago, 2005.)

If collateral is not perfected (registered properly), MFIs run the risk of not having a last resort for collecting on delinquent loans. Also, another entity could possibly place a first lien on the collateral if it is not perfected. MFIs need to know exactly how to perfect collateral in their own country. To do this they should consult with attorneys to find out the specifics. Also, they should try to figure out ways to make the process less expensive, cumbersome and time consuming for their clients. If they are able to help their clients in these ways, they will have a market advantage. Clients loathe this experience and would welcome any aid in cutting costs and time. Some tips and strategies are listed in the next session.

Example of the Step-by-Step process of perfecting real estate in one country in Asia:

Prior to disbursement of the loan:

1. The client obtains form #2 from the state body that is responsible for registration of tenants and collection of house maintenance fees, called JKE. This form proves the official tenants registered in that house. There is no official cost for getting this form (usual unofficial cost is around $5).
2. The client and all other tenants (spouse and children over 16 y/o) must give a written permission to pledge the house. These letters must be notarized (cost for notarization of each letter is $11).
3. The client applies to BTI for a valuation of the property. BTI sends its appraisers to measure the area of the house and value it. This can take up to 30 days and officially costs $10 to $15. The valuation can be expedited (3 days) for up to $150.
4. The client applies to BTI to obtain form #10. This form shows whether this house is currently collateralized or not. It also documents the appraised value. This is calculated according to the tariff of the BTI. The payment for the form is regulated according to the value of the house. The official cost of this form is between $11 and $25 and the official timeframe to obtain it is up to 30 days. In order to "speed up" the process (within 2-3 days), the client may be requested to unofficially pay $100-$200.
5. The bank signs the collateral agreement with the borrower and attaches the ownership documents for the house.
6. The Credit Officer sends a letter to the BTI requesting a lien to be placed against the house.
7. The BTI sends a letter informing the bank that the house has been registered. The official timeframe to receive this confirmation letter is 30 to 45 days. If the client would like to speed up the process, the unofficial cost of $25 to $50 to receive the letter within 2 –3 days.

Summary of registration processes, timeframe and costs:

Step #	Action	Lender	client	Organisation	Approx. Official Timeframe (unofficial)	Official Costs (USD)	Unofficial Cost (USD)
1	Form # 2		X	JEK	2 days		$5
2	All tenant's permission to pledge the house and its notarization		X	Notary	1 day	$11 (for each letter)	
3	Valuation of house, Form #10		X	BTI	30 days (3 days)	$10-$15	$15-$150
4	Form #10		X	BTI	30 days (3 days)	$11-$25	$100-$200
5	Signing collateral agreement	X	X		1 day	N/a	N/a
6	Request to register collateral	X		BTI	30 days (3 days)	N/a	$25-$50
Total					**94 days (12 days with unofficial costs)**	**Minimum $32 Maximum $51 plus $11 per additional household member**	**Minimum $145 Maximum $405**

Q: What are some practical, real life tips and strategies?

<u>Tips for MFI Collateral policy and implementation:</u>

1. Use professionals or trained staff to value collateral, especially for land or property.
2. Value according to real market values using comparison data.
3. Update comparison data regularly.
4. Standardize your method and procedures. Be consistent.
5. Set the maximum ratio around Loan to Value = 80%, OR Value to Loan = 125%.
6. Randomly control collateral valuation by including it in the internal audit & control function.
7. Reassess collateral value during monitoring visits.

(Tjossem, 2004)

<u>MFIs can reduce costs and expedite the collateral process in the following ways:</u>

1. Use pre-selected, pre-approved law firms / notaries to provide affidavits and other legal services at a reduced bulk rate for your clients.
2. Hire an in-house lawyer/professional to check/verify contracts, and provide file reviews and advice to the MFI and clients.
3. Hire a "Loan Expeditor" to aid clients through the bureaucracy and demystify registration, as well as reduce costs per client.
4. Provide clients with a written "Step by Step Process to Register Collateral" for each type of collateral.
5. Use collateral contracts that can cover multi-loans over an extended period so the client registers once, but can use the collateral for several consecutive loans.
6. Arrange for borrower discounts for regularly used services, such as insurance and notary services.

(Tjossem, 2004)

MFIs that have special ways to reduce costs and expedite collateral processes will have a market advantage.

Q: What do Credit Officers need to be aware of?

Red Flags:

- Beware of clients who do not wish to sign a personal guarantee and have difficulty obtaining third party guarantees from tribal chiefs, local officials, relatives and/or friends.
- If a current owner of a business does not want to pledge collateral or sign a third party guarantee, there may be internal disputes that can negatively affect the business.
- Be sure that ownership and titles match the borrower's name and that spouses also sign collateral agreements.
- Make sure to check collateral when monitoring. Collateral that has disappeared or significantly lost its value can be one of the first signs of trouble.
- Make sure to use collateral that fits the country's conditions and legal system.
- Overvalued collateral is a typical problem to watch out for.

Q: What are some of the possible risk reduction strategies?

- Some of the risk reduction strategies used include:
- Salary-based lending against terminal benefits (EA) – Basically, in South Africa, EA is giving loans to clients and using their terminal (or life insurance) benefits as collateral. In case of default, EA has the right to claim the outstanding balance and interest owed from the terminal benefits. MFIs need to very clearly understand their legal environment, as. As in most countries, terminal benefits and pension funds are protected and can not be used as security.
- Account flags to prevent withdrawal of savings – Many MFIs have savings or cash deposit requirements for loans (sometimes called voluntary savings). These are for

the purpose of securing part of the loan in case a client does not repay. Usually the amount is not sufficient to cover the whole outstanding balance. In case of delinquency, the bank needs to be able to automatically flag and stop withdrawals from the savings account to make sure these monies are not withdrawn. In case of non-payment, the savings will be used to offset the amount owed.

- Guarantors – Friends and relatives who have regular salaries serve as guarantors for clients. In case of delinquency, the guarantors are used to help find the clients and pressure them into repaying. Guarantors are expected to help repay the loan in case of prolonged delinquency. In some countries, MFIs are able to automatically deduct the payments from the guarantors' salaries. MFIs must be careful, as often guarantors can get overburdened, guaranteeing many loans at the same MFI and/or multiple MFIs.
- Spouse as guarantors – MFIs should always take guarantees from spouses stating that the spouse understands the loan contract and terms and agrees to them. There have been far too many cases where the spouse has not signed an agreement. The MFI had a lien against a property that was jointly owned and therefore could not collect.
- Having a clear policy that spells out collateral guidelines clearly and unambiguously.
- Monitoring collateral – It is important for the MFI to have a policy for monitoring collateral that can be a part of its overall monitoring policy. It is suggested that the Credit Officer examines the collateral at least every six months and definitely before a new loan is disbursed. S/he should pay particular attention to the changing nature of collateral, including the level and condition of inventory, equipment that is still on the premises, condition of the building or residential property, ownership of collateral and the overall environment in which it is kept.

Session 8: Loan Structuring

Most borrowers, all around the world, large or small, ask for more money and a longer term than they really need. Taking too large of a loan is one of the major reasons for default. MFIs are often at fault for giving too large of loans to repeat customers, without truly taking into account their ability to repay. Clients are always better at taking money than repaying it. The challenge for a Credit Officer is to identify how much money is appropriate and how the payments should be structured. The Credit Officer should not necessarily give what the client requests, but work with clients in making them ultimately see why proper loan structuring is better for them. Again, the loan policy should provide clear guidelines for the Loan Officer, so that excessive discretion is not used. Exceptions to policy should be sanctioned by a superior.

Caught in cahoots!
Upon auditing one MFI, a consultant found that the clients received exactly the amount, frequency and term they had requested in their application in 44 out of 55 loans. Most borrowers do not truly understand their cashflow and repayment capacity and will **not** receive exactly what they ask for, neither amount nor term.

Q: What is Loan Structuring?

Loan structuring ensures that:

- ✓ The right amount of money is lent,
- ✓ for the right amount of time,
- ✓ with the right repayment frequency, and
- ✓ under the right circumstances.

These items are further detailed below.

Proper loan structuring reduces the risk to the lender and the borrower. It can determine good repayment or delayed repayment/non-payment. Loan structuring is the last and one of the most important steps of analyzing and disbursing a loan.

Q: What are the risks associated with Loan Structuring?

The risks associated with loan structuring are:

- ✓ The larger the loan, the larger the risk
- ✓ Too much money is lent
- ✓ Too little is lent to complete the project
- ✓ The longer the term, the larger the risk
- ✓ The right conditions are not set for disbursing or securing
- ✓ The payment frequency does not match the business's operating/cash cycle

It is important for the participants to understand that the Credit Officer does not just analyse the client, do the cashflow, calculate the repayment capacity and then give the maximum loan amount and period. The repayment capacity determines the maximum loan amount, but does not determine the right loan amount!! The loan has to also fit the type of loan and business needs. Good loan structuring can determine good repayment or delayed repayment/non-payment. Loan structuring is the last and one of the most important steps of analyzing and disbursing a loan.

Q: Why does the size of the loan matter?

The loan size should be enough to fulfil the needs of the project, but should not be too much so that repayment becomes unmanageable. Giving too large of a loan can put the borrower in jeopardy. No matter how much s/he might WANT to repay, s/he may not BE ABLE to repay. Does the customer WANT to repay and will the customer BE ABLE to repay?!!!

> In a recent evaluation of three very large south Asian MFIs, one of the two main causes of default was **granting a larger loan amount than necessary, or granting a second loan (at the same time as the first loan or larger loan) to the same borrower, which has the same effect. If the MFI allows overdrafts on a checking account, the problem is often worse, as it is hidden.**

Q: Is it good for the customer if we give the longest term loan available?

Giving a loan for too long a time allows the entrepreneur to use it for lots of purposes that you may not have expected (and which may not be successful!). If their business cycle is shorter, they may have to save up to repay the loan later on and this may be a very difficult thing to do when they also have other, household expenses. Also, customers pay the MFI interest on the amount they have outstanding. If they can pay the loan earlier, it will be cheaper for them!! If they repay exactly on time, they will be able to get a larger loan the next time! It is best to give a loan term that corresponds to the loan use. For example, shorter term loans are better for working capital and longer term loans are more suited for buying equipment and fixed assets.

Q: What are the dangers of a loan with too short of a term?

Giving a loan for too short a time can mean that the entrepreneur's repayments will be too large and they will not BE ABLE to make their monthly payments.

The trainer must explain that it is the Credit Officer's job to match the type of business and loan to the repayment period within the policy guidelines. Just because a MFI only gives loans for 24 months, it may not be appropriate to give a loan for building a dormitory for this period. Giving a loan for too short a time can mean that the borrower's repayments will be too large and they will NOT BE ABLE to make their monthly payments. Generally, shorter term loans are for working capital purposes, while longer term loans are for fixed asset purposes. If there is a good business reason for an exception to the policy, the Loan Officer should go ahead and make the case to his/her superior.

Also, the Credit Officer must choose the best loan for the client, based on the best, verified information – not just to give the loan the client requests. The Loan Officer needs to be clear with his/her customers. Explain that taking too large or too small of a loan for too short or long of a loan period may negatively affect the client's business.

If clients want a longer term loan than reasonable for working capital purposes, the Credit

Officer should present a sound argument why this would be a bad idea. For example, the Loan Officer could do a calculation showing that the client will be spending too much money on interest and have difficulties in repaying. The Loan Officer can also explain that the client can always get a subsequent loan if s/he feels that the first one was not large enough.

Q: What are the steps to building a good structure – loan structure?

The keys to building a good loan structure are:

- **Step 1: Loan Amount and Repayment Capacity**
- **Step 2: Repayment Structure**
- **Step 3: Disbursement & Other Conditions**

Step 1: Loan Amount and Repayment Capacity (How much to lend?)

The Credit Officer needs to analyse two parts in this step:
1.1. The borrower's needs
1.2. The borrower's repayment capacity

Q: 1.1. How does the Credit Officer determine the borrower's needs?

Loans are made for a particular purpose. The Credit Officer should determine that the project costs are reasonable in the given market and if the owner is contributing. If these are confirmed, then the Credit Officer determines the best loan size for the client's project. Do not always give the loan amount the client requests. The Credit Officer should understand and check the costs of achieving the borrower's plan (as well as match this with the repayment capacity of the client).

Sometimes borrowers forget to include important parts of the project. For example, transport for the goods. It is the job of the Credit Officer not to cut the loan to the bare minimum, but to help the borrower determine what is best and that the project costs are reasonable. Credit Officers should not necessarily give the loan amount the client requests. The Credit Officer should understand and check the costs of achieving the borrower's plan.

Reader should think about this exercise:

Project costs of a bakery:

Machinery	2,000,000
Renovation	1,000,000
Flour & other	1,000,000
Working Capital	1,000,000
TOTAL	**5,000,000**

Reader should answer the following two **questions:**

1. What would you ask this borrower about the project?
2. What would do to confirm the costs as a Credit Officer?

Possible answers may include:

1. Is this a new project or expansion of a current business?
- Exact machinery, at what capacity and what for?
- What sort of renovation is necessary?
- Have the details been checked?
- Have provisions been made for cost and time overrun?
- Flour is needed for what period? Is this long enough? Or too long?
- What does working capital consist of? For what period? Is this long enough or too long?

2. Compare project and figures with other bakery loans.
- Check details of equipment and other material costs at the market.

Q: What is the Project Cost Table Tool?

The Project Cost Table tool makes determining the needs of the client and owner's contribution easy (participants were introduced to this during Session 4, as it is part of the Loan Appraisal Tool). This table lists the items to be purchased for the project and determines how they will be paid for, with loan funds or with the owner's contribution.

Although the Project Cost Table gives a very clear picture of the loan use and how much each item will cost, it does not verify these costs. It is up to the Credit Officer to check the market prices to make sure they are reasonable. It also plainly shows the owner's contribution to the specific project.

Sample:

Project Costs for an optical shop:

Item	Loan	Owner's Contribution	Total Project Cost
1. Raw materials for optical shop	$3,000	$1,300	$4,300
Total	**$3,000**	**$1,300**	**$4,300**
% of Total	**70%**	**30%**	**100%**

Q: Why would a MFI require an owner's contribution or consider it important?

As the lender, we want to know that the owner is also willing to contribute (risk) some of their own money to prove commitment to the business and project. In general, the more the owner has at stake (i.e. is at risk), the better.

Many MFIs require their customers to invest their own funds (i.e. up to 20% of the project costs). This is especially true for start-up companies and new lines of service. The amount of loan, therefore, might depend on how much the borrower has to invest.

Note: Some MFIs include items purchased by the owner in the **six months before loan disbursement** as owner contribution, not older assets or planned investments after the loan is disbursed! Sometimes owners spend all their money on a project and then come to the bank when they run out and have not completed the project. For example, a new piece of machinery purchased last month can be counted. However, the present inventory of a company cannot be counted as owner's contribution. Only the GROWTH in the inventory over the last six months can be accepted. This figure can be very difficult to determine unless it is a repeat loan.

Q: 1.2: How does the Credit Officer determine the borrower's repayment capacity?

The repayment capacity of the borrower is proven through the use of two tools, the Loan Appraisal Tool and Cashflow Tool, which includes the Repayment Capacity formula. When structuring the loan repayment, the credit officer must ask themselves five key questions before proceeding with the loan repayment schedule. These questions aid in reviewing their diligence in completing the Loan Appraisal Tool and Cashflow Tool to make sure that all the pertinent information has been thoroughly completed and verified internally and externally before the loan is structured.

The reader may note that potential income (with the loan) may be higher than current and/or historical income. In ShoreBank's experience and according to best practices, it is far better to rely solely on historic cashflows, rather than projections that are more subjective. This is especially important in developing (un-transparent) markets, where assumptions can be wildly off target. Obviously, for start up businesses, this is not possible.

For start up businesses, credit officers should be extremely cautious and conservative, given the higher level of risk associated with start-ups. They should base their calculations on conservative figures from another like business, taking particular nuances into consideration (capacity of equipment, location of business and experience of owner, compared to the like business).

5 Key Questions:

1. Are cashflow costs verified and reasonable? Answer this question while comparing the loan with loans given to similar businesses.
2. Are the costs for producing the product or delivering the service over- or underestimated?
3. How long is the cash cycle? Is there a cushion for a longer cash cycle?
4. Does the experience of the borrower fit the loan amount, terms and project?
5. Is the owner's contribution sufficient, accurate and verified?

Details regarding the 5 Key Questions the credit officers must ask themselves:

1. Are cashflow costs verified and reasonable? Answer this question while comparing the loan with loans given to similar businesses.

One of the most important points here is to ensure that the cashflow is reasonable (sales and expenses) and that the repayment capacity has been calculated properly. If the cashflow is not realistic, the Credit Officer is putting the borrower in jeopardy of defaulting. The foundation of all the loan decisions must be made upon good, complete information and a good cashflow.

All costs in the cashflow must be verified and reasonable, according to market prices. Credit officers should go to the market and check current prices and also compare this loan with other like business loans. This gives a good sense of the type of business. After a while a Credit Officer will know all types of businesses and common sales prices, costs, expense categories and amounts, and equipment costs. It becomes second nature.

2. Are the costs for producing the product or delivering the service over- or underestimated?

This should be based on the business historical cashflow. Sometimes costs can be difficult to determine or are left out. Some examples of typical costs not included are administrative and sales employees' time, transport costs and losses from items that have been damaged. Costs must be kept conservative so that the business does not have difficulty in repaying the loan, but not too conservative so that the business has more cash than they know what to do with. It may be that because the borrower wants to try something new, he needs a piece of machinery that would not be available on the local market. Factor this in and connect it to borrower's experience with the business to decide; is it worth the added delivery costs and learning to use a new machine?

Ask: Why do we not want the borrower to have too much cash on hand?

Answer: Because the borrower may take it out of the business and spend it on some other risky venture or personal matter, putting the loan repayment at risk.

3. How long is the operating or cash cycle? Is there a cushion for a longer cash cycle?

Cash cycle: How long is the period from when a client receives the loan funds to when they buy a product and to when cash is received from a customer who buys the product? The cash cycle for a bakery that buys flour on a weekly basis and produces bread daily is 1 day. A carpenter shop that produces school desks for schools might buy the raw materials in May, make 1000 desks, and then sell them in August, resulting in a cash cycle of 3 months. There should be a cushion in case the cash cycle is longer than predicted. For example, if considering a trade business, then approximately 7 days is appropriate. If considering a production or service-based business, allow for an approximate 25% delay in the cash cycle.

4. Does the experience of the borrower fit the loan amount, terms and project?

Look at the experience of the borrower: Should s/he take a smaller loan if this is a new business for her/him, or if there is some change with the expansion of her/his business? Should the Credit Officer test the borrower and build trust and credit history before giving a big loan?

5. Is the owner's contribution sufficient, accurate and verified?

vvv

Q: After the Credit Officer has verified everything and is happy with his/her answers to the five key questions, what happens next?

Based on the net income of the household and business, Credit Officers should determine the maximum repayment capacity per month, as explained in the session on cashflow. Some MFIs have a percentage limit (i.e. 35% - 75%) of the business and household cash, which can be used for repayment of a loan. Other MFIs set the limit according to only the business cashflow calculations. Using only the business cashflow can be dangerous if the household expenses are more than expected and they are not taken into account properly.

The repayment capacity is set by the MFI and can change depending on the situation. The repayment capacity can be country or MFI specific, as you know your borrower's tendencies. Do they tend to have many unaccountable costs (set it lower) or are they pretty true to their cashflow (set it higher)? It is better when launching a product to be more conservative and adjust the repayment capacity, as needed. MFIs may want to set it lower for start-ups, as they may need a greater cushion, due to not knowing their real costs. If delinquency has increased, the MFI may want to adjust the repayment capacity down.

Examples of various Repayment Capacity Policies:

BRAC Bank, Bangladesh: "…seasonality of sales are taken into account when estimating future sales and other family expenses are also considered in the estimation of net income. The maximum loan amount should not exceed 75% of the sum of average inventory + good receivables, if any, of the previous year provided that the monthly repayments do not exceed 75% of estimated monthly net income."

Association of Cambodian Local Economic Development Agencies: The repayment capacity is a percentage of the estimated monthly net income of the borrower.

67% if the borrower's credentials are excellent, based on fair and truthful information collected, with strong collateral and very good guarantors.

50% if the borrower is rated as advantaged and has given fair and reliable information.

33% if the borrower has a start-up business and there is a high risk probability of repayment problem.

The repayment capacity cannot exceed 67% of the estimated monthly net income of the borrower for any loan.

Micro Enterprise Bank, Philippines: After the credit analysis, the Credit Officer makes a recommendation, including the loan amount, loan maturity period, interest rate, repayment schedule and items to be collateralized. Normally, the loan amount is not more than 50% of the total net disposable income of the client. Only the Executive Management can approve any exceptions.

(ShoreCap Exchange SME Training, Manila, 2005.)

Q: How do we get from maximum repayment capacity to maximum loan amount?

In the *MicroSave* and ShoreBank methodology, both business and household income and expenses are used to calculate cashflow and then a percentage of the remainder is taken to determine repayment capacity per month. This simple formula will enable the Credit Officer to determine the maximum loan with a flat rate of interest for the given period.

Maximum Loan Formula = ((NI*ARC)/(1+r))*t

Adjusted Repayment Capacity	ARC
Net Income	NI
Loan term (monthly)	t
Interest rate (flat) per annum	r

The MFI can also predetermine the loan amount and terms for the repayment schedule. Since many Credit Officers make mistakes in calculating, this solves one possible calculation error. For example, the Credit Officer chooses the appropriate repayment schedule from the table that includes the loan amount in increments of $100 and the loan term in increments of 3 months from 6 to 24 months.

Exercise for the reader to try:

Bakery Case Loan Details:
Loan amount = 5,000,000 (assume this has been verified and client needs it)
Client's net income per month = 1,100,000
Repayment capacity = 50%

Readers should try to find the most appropriate from the table below:
Maximum Monthly Repayment =
Monthly Loan Payment =
Loan Term =

Repayment Schedule possibilities - Equal payments per month

loan	1,500,000	2,000,000	2,500,000	3,000,000	3,500,000	4,000,000	4,500,000	5,000,000
interest rate	30%	30%	30%	30%	30%	30%	30%	30%
interest pmt	450,000	600,000	750,000	900,000	1,050,000	1,200,000	1,350,000	1,500,000
total pmt	1,950,000	2,600,000	3,250,000	3,900,000	4,550,000	5,200,000	5,850,000	6,500,000
term	6	6	6	6	6	6	6	6
monthly pmt	325,000	433,333	541,667	650,000	758,333	866,667	975,000	1,083,333
term	9	9	9	9	9	9	9	9
monthly pmt	216,667	288,889	361,111	433,333	505,556	577,778	650,000	722,222
term	12	12	12	12	12	12	12	12
monthly pmt	162,500	216,667	270,833	325,000	379,167	433,333	487,500	541,667
term	15	15	15	15	15	15	15	15
monthly pmt	130,000	173,333	216,667	260,000	303,333	346,667	390,000	433,333
term	18	18	18	18	18	18	18	18
monthly pmt	108,333	144,444	180,556	216,667	252,778	288,889	325,000	361,111
term	24	24	24	24	24	24	24	24
monthly pmt	81,250	108,333	135,417	162,500	189,583	216,667	243,750	270,833

* MFIs should tailor the Repayment table to fit their own loan amounts and interest rates.

Answer:
The Maximum Monthly Repayment would be 550,000 (1,100,000 x 50%).

First, the Credit Officer verifies and justifies the loan amount. Once the loan amount is settled, s/he looks down that column to choose the monthly payment and term. Since the project costs of 5,000,000 are justified, and the client can afford it, the Credit Officer looks at the 5,000,000 column and chooses the appropriate monthly payment that is less than 550,000.

Six and nine month terms have monthly repayments that are too high, 1,083,333 and 722,222, respectively. The Credit Officer must choose 12, 15, 18 or 24 months. The Credit Officer should choose between 12 and 15 months, since 18 and 24 months would give the client too much time and therefore excess cash. To choose between 12 and 15 months, the Credit Officer should review the loan purpose. In this case, the Credit Officer may want to choose the longer term, 15 months, given the client's intention to purchase equipment and renovate a building.

The Credit Officer needs to match the loan amount to the borrower's actual needs and the loan term to the purpose of the loan. Working capital loans should have shorter terms, of 6 to 12 months. Loans to purchase equipment and fixed assets should have longer terms, of up to 24 or 36 months.

How would the following scenarios affect your decision?
1. This is a start-up business.
2. The client has excess cash.
3. The client wants a 24 month loan term.
4. This is the client's 4th loan and a few of the repayments have been delinquent.

Repayment Capacity percentages are set by the MFI according to their experience in the market. It is better for the MFI to be more conservative at the launch of a product and then ease up if it is going well.

Q: What are the choices for the repayment structure?

Step 2: The Repayment Structure

Main repayment frequency options:
Option 1:. Equal weekly/monthly payments throughout the loan
Option 2:. Equal weekly/monthly payments after a short period of interest only
Option 3:. Unequal weekly/monthly payments
Option 4:. Seasonal payments

Duration of loan:
Short to Long term

The duration of the loan can vary between short and long–term. For individual lending with micro and small enterprises, is usually between 6 and 24 months.

Q: How is the repayment structure determined?

Credit officer Clues: the best option for repayment structuring is based on:

- ✓ Type of Cashflow: Regular, Irregular or Seasonal (includes ALL cashflows)
- ✓ Type of Loan: Working Capital (shorter term) or Fixed Asset (longer term)

The repayment structure depends on the type of business and its needs. Based on the cashflows of the business, the Credit Officer chooses between a Regular (Option 1 and 2), Irregular (Option 3) or Seasonal (Option 4) repayment schedule. In the second part, the credit officer must match the purpose of the loan with the duration of a loan. Generally, loans for working capital receive shorter terms than loans for fixed assets. The repayment structure must also be matched with Step 1 loan amount and capacity. For example, a business with a regular cashflow and requiring a loan for working capital should not receive a loan for 24 months, just because the borrower wants a large loan amount and cannot afford repayment terms of 12 months.

Note: A MFI may have quite restrictive/standardized loan terms, so a farm or craft business, for example, may not fit with any of its products. The farm business, which produces wheat twice per year, would not be able to take a loan that only has monthly repayment terms. The reader should consider the types of businesses they are targeting and whether these are suited for a standard or more tailored loan product.

Q: What is the last step, disbursement and other conditions?

Step 3: Disbursement and Other Conditions

The Credit Officer designs conditions that will ensure that the loan is used for the correct purpose and is less risky! Once the loan amount and repayment structure are decided, the Credit Officer should think about what other conditions of disbursement should be applied.

Remember: Loans are for a specific purpose and the Credit Officer should aim to ensure that the money is used for that specific purpose by setting appropriate conditions! Clients who divert funds away from the intended loan purpose often find that they have trouble making repayments, as working capital may not be sufficient to generate the cashflow to make the instalments.

Risk Reduction Strategies or Guidelines that a Credit Officer **should follow:**

1. The owner should always invest their portion either BEFORE or AT THE SAME TIME as the BANK loan.

This is important so that the owner shows his/her commitment to the business by investing first. Also, even if the MFI requires the owner's investment, sometimes the borrower will not invest his/her own money after s/he receives the loan. Be sure to verify the investment before disbursing the loan.

If the owner fails to put their agreed investment into the business, the loan will not be disbursed.

2. For moveable assets, sometimes the MFI can retain the title to the equipment bought with the loan proceeds. The equipment belongs to the entrepreneur ONLY once the loan is repaid.

MFIs retain the title in case of default, so that it is easier to repossess the collateral, if needed. It is also a kind of psychological pressure for the borrower, knowing that the equipment is not his/hers until s/he repays the loan. MFIs must determine if this is legal in their specific country. Also, the MFI may have to carry the equipment on their balance sheet until it becomes the clients' property which would inflate the balance sheet of the MFI.

3. Wherever possible, the loan payment can be paid directly to the supplier of the inventory, equipment or property. Otherwise, the Credit Officer should go with the entrepreneur when

they use loan funds to make a purchase or at least check within one week that the items to be purchased were actually purchased.

> It is very important to ensure that the loan funds are used for the purpose of the loan. Disbursing the funds to the supplier of the inventory, equipment and/or property is a risk reduction strategy to ensure that the funds are not diverted and items are priced properly.

4. In addition to other collateral, all items purchased with the loan should be taken as collateral.

This is just to indicate to the borrower that the items are not owned until the loan is fully repaid. In reality, the MFI should not take part of the business assets from the borrower to repay a delinquent loan. If the MFI takes the plastic moulding equipment, for example, the borrower will have no way to earn money to repay the loan. On the other hand, if the borrower is not repaying even though s/he is making an income, then the MFI should seize the asset as a last resort.

5. If the loan is for a series of purchases or for a building project, it should be disbursed in small pieces called 'tranches' – as the entrepreneur needs the funds.

This ensures that the project, especially a building or renovation project, is completed as it was planned. The Credit Officer checks each stage of the project. This is also done where the owner is investing. For example, if the owner contributes first, the items should be checked before providing the loan. The disbursements should be controlled and limited to a maximum 3 tranches (otherwise it becomes somewhat cumbersome to manage).

> MFIs lower risk by giving loans in tranches. Thus, the entire loan amount is not outstanding until the project is almost complete. Construction loans always seem to go awry and this is one way of controlling them.

6. Always take personal, spouse and business guarantees.

Guarantors should sign that they "personally" guarantee the loan. Don't get caught without the spouse's or other business partners' guarantees, as they could potentially be unaware of the loan.

> Collateral may be uncollectible if the spouse, who is a joint owner, did not give a guarantee.

7. If the business is managed by someone other than the owner, take a personal guarantee from the manager and all others who are responsible for the business! If the manager easily gives a personal guarantee, this is a good indication that s/he thinks that the business is doing well and s/he trusts the owner. However, there is no way to enforce this guarantee. In case of default, the MFI should not necessarily try to collect from the manager, as it is not their loan or commitment.

Standard Lending Conditions (ShoreBank Advisory Services, 1999)

Below is a complete list of standard lending conditions. The Credit Officers should only choose the items that are necessary. They should reduce it, as appropriate, based their own conditions for the borrower, according to MFI policy and their environment. They can put the conditions into categories, such as required and additional.

SECURITY

1. Receipt of first security interest on commercial property located at: ADDRESS, prior to first disbursement.
2. Receipt of first security interest on residential property located at: ADDRESS, prior to first disbursement.
3. Receipt of first security interest on machinery and equipment to be purchased with loan proceeds, prior to or concurrent with loan disbursement.
4. Receipt of first security interest on machinery and equipment located at: ADDRESS, prior to first disbursement.
5. Receipt of first security interest on all inventory being purchased with loan proceeds, prior to or concurrent with loan disbursement.
6. Receipt of first security interest on all inventory located at: ADDRESS, prior to first disbursement.
7. Receipt of first security interest on automobile being purchased with loan proceeds, prior to or concurrent with disbursement of loan.
8. Receipt of first security interest on vehicle owned by: NAME, prior to first disbursement.
9. Receipt of personal guaranty from other owners of same business: NAME, prior to first disbursement.
10. Receipt of personal guaranty of spouse or closest relative: NAME, prior to first disbursement.
11. Receipt of corporate guaranty of COMPANY, prior to first disbursement.
12. The collateralized items for this credit must be insured up to a value no less than the loan value and assigned to the Bank. Insurance will be proportionally distributed between the collateral according to liquidation value.
13. Receipt of assignment of all rental and lease income accruing from the commercial property located at: ADDRESS for the term of the loan, prior to first disbursement.
14. Receipt of assignment of life insurance on: NAME in an amount no less than: DOLLAR AMOUNT, for the term of the loan, prior to first disbursement.
15. Receipt of borrower agreement to incurring no additional debt or capital expenditures for the life of the loan without the prior written consent of the Bank.

VALUATION

1. Receipt of evidence, satisfactory to the BANK that the commercial property located at: ADDRESS has a market value of not less than: DOLLAR AMOUNT, prior to first disbursement.
2. Receipt of evidence, satisfactory to the BANK that the personal property located at: ADDRESS has a market value of not less than: DOLLAR AMOUNT, prior to first disbursement.
3. Receipt of evidence, satisfactory to the BANK that the existing machinery and equipment being taken as collateral has a market value of not less than: DOLLAR AMOUNT, prior to first disbursement.
4. Receipt of evidence, satisfactory to the BANK that the existing inventory being taken as collateral has a market value of not less than: DOLLAR AMOUNT, prior to first disbursement.
5. Receipt of evidence, satisfactory to the BANK that the automobile being taken as collateral has a market value of not less than: DOLLAR AMOUNT, prior to disbursement.

OTHER CONDITIONS

6. Receipt of evidence of borrower’s injection in an amount not less than: DOLLAR AMOUNT, prior to loan disbursement.

7. Receipt of insurance on all collateralized assets in an amount not less than the loan plus principal amount, prior to disbursement.
8. Receipt of evidence, satisfactory to the BANK that borrower has all necessary licenses and permits to operate, prior to disbursement.
9. Receipt of borrower's agreement to limit dividends/owners draws during loan repayment to an amount no greater than: DOLLAR AMOUNT, prior to disbursement
10. Receipt of evidence, satisfactory to the BANK that borrower is in full compliance with all environmental regulations, prior to first disbursement.
11. The BANK's Credit Officer must check the items purchased with the loan proceeds within a period of one week after disbursement for quantity, prices and compliance with contract and document this in the clients' file.

Credit Officers should avoid setting too many lending conditions. In the end, the loan will either not be disbursed because the borrower cannot meet all the conditions or not be repaid because it is too difficult and/or costly to comply with all the conditions.

Q: Are there any last minute tips to follow for structuring?

TIPS to keep in mind when you are structuring a loan:

1. **Interest-only periods should be kept to a minimum.**

   In most businesses that have regular cashflows, there is no reason to give an interest only period. It is much easier for the client to get in the habit of repaying the loan in equal monthly instalments from the beginning than to change in the middle.

Grace periods are NOT recommended! The client needs to get into the habit of at least paying a little bit to the bank on a regular basis. It is also important that the client comes to the bank and feels some connection with the institution.

2. **Do not set overly tough conditions for the client.**

   In most cases, if a Credit Officer has set overly tough conditions, either the loan will not be disbursed at all or the client will have difficulty in repaying.

3. **Train the client to make repayments on time.**

   By making this part of the MFI's culture and also giving 'carrots' for good repayment behaviour, a MFI can reduce the amount of time spent on collecting delinquent loans and use this time for new loans. Make sure that on-time repayment is instilled in the client during the analysis, disbursement and monitoring processes.

4. **Repayment terms should correspond to the type of business, cashflows, and loan purpose.**

5. **Follow the steps for restructuring to fit the type of business, cashflows and loan purpose to the repayment terms. This will ensure better repayment. Don't just give the client what they ask for.**

6. **Along with the steps for structuring, these tips can aid in finding the best structure for the MFI and the client.**

Q: Is there a way to determine an ideal structure?

By carrying out market research, a MFI can come up with the most ideal loan structure for clients. This is important for standardization and making the process quicker. This also takes a major step out of the Credit Officer's hands, where there can be a lot of ambiguity.

Q: What are some of the Red Fags?

Red Flags:

- Loan structuring will fail if it is based on incorrect information from the Application, Loan Appraisal and Cashflow.
- The Credit Committee should be wary of loans for the exact amount, repayment frequency and term requested by the borrower and/or inadequate conditions.
- Be wary of borrowers who do not want to contribute or do not fund the owner's contribution first.
- Be wary of clients who do not purchase items with loan funds in a timely manner.
- Be careful if a spouse, business partner or manager does not want to give a personal guarantee.
- Be wary when many loans are approved at the maximum authorization level for a branch, to avoid getting a sanction from head-office for larger size loans.

Structuring decisions are among the most important because they dictate whether or not the customer will BE ABLE to repay, even if they WANT to repay! Loans that are not structured correctly will either not be disbursed (too many conditions or conditions that are impossible to meet) or not be repaid.

Session 9: Loan Approval and Documentation

Q: What is the file cover sheet and when does a Credit Officer use it?

The File Cover Sheet and Closing Checklist Tool summarizes and prioritizes all the forms and documents that the Credit Officer must collect and keep in the borrower's file during the loan due diligence, approval, disbursement, repayment and monitoring processes. A client file is started at the site visit stage. Throughout the entire analysis, disbursement, monitoring and repayment process, the Credit Officer updates the file with new documentation by registering and signing for each new entry.

Q: What are the sections of the Checklist?

The sections of the checklist follow the step-by-step lending process of the MFI, by detailing the documents and procedures/processes to be followed at each stage. It begins with personal information and loan details (filled in after approval and disbursement), continues with the introduction, loan appraisal, approval and disbursement, and then ends with monitoring. It is not important for the items in the sample checklist to fit your particular MFI. Each MFI will need to tailor this list to their specific situation.

Sample FILE COVER SHEET / CLOSING CHECKLIST

Project #			
Company Name		Borrower's Name	
Company's Address		Borrower's address	
Company's Phone		Borrower's Phone	
Credit Officer			
Loan Amount		Payment frequency	
Loan term	Months		
Interest rate per month	% per month flat		
Disbursement Date	, 200__		
Due Date	, 200__		
Other conditions			

*All information above is necessary.

	Item	Completed	Date	Initials
1.	Screening Form *			
2.	Information Session Completed			
3.	Loan Application Form *			
4.	Passport Copy, MFI I.D. *			
5.	Photo collected *			
6.	Business Charter, Registration and License(s) copies			
7.	Supervisor signature (proceed or reject) *			
8.	Real Estate Assessor's (Credit Officer) valuation of collateral *			
9.	Written Verification of Credit History			
10.	Bank account statements for last 6 months			
11.	Quotes from suppliers for equipment and supplies			

	Item	Completed	Date	Initials
12.	Contracts with main suppliers copies			
13.	Contracts with main customers copies			
14.	Verification of items to be purchased with loan *			
15.	3 Reference checks of Borrower * (customers/suppliers/neighbours/ competitors)			
16.	Loan Appraisal Form Completed *			
17.	Cashflow form completed *			
18.	Inventory form completed *			
19.	Ownership papers for equipment			
20.	Ownership papers for bus. premises or Rental Agreement			
21.	Ownership papers for other collateral, specify: ______________			
22.	Program Manager agrees to send to Credit Committee *			
23.	Sent to MFI Credit Committee*			
24.	MFI Approval and signatures*			
25.	Copies of Licenses necessary for business through loan term			
26.	Customs Declaration for: ___________________________			
27.	Invoices for: _____________________________________			
28.	Insurance Policy			
29.	Personal and Spousal Guarantees *			
30.	Business Guarantees *			
31.	Third Party Guarantees *			
32.	Conditions of Loan completed: * – –			
33.	Collateral Agreement and Schedule signed in 2 copies *			
34.	Original notarized collateral registration documents *			
35.	Loan Agreement completed and signed in 2 copies *			
36.	Repayment Schedule *			
37.	Ownership and Collateral documents for equipment or real estate purchase with loan proceeds and owner’s contribution			
38.	Conditions Fulfilled Document sent to Manager *			
39.	Disbursement Request sent to Manager *			
40.	Client received Loan Proceeds according to specifications *			
41.	Document confirming bank transfer or payments to: ____ *			
42.	Monitoring Schedule*			
43.	Monitoring Reports/Documents*			
44.				
45.				
46.				
47.				
48.				
49.				
50.				

The items which would be required as a bare minimum are starred (*) above.
(Tjossem, 1999)

Bank Rakyat Indonesia Loan Documentation Requirements

A typical micro loan file would include the following:

1. Cash Receipt form
2. Copy of the borrower's identity card
3. Application form
4. Copy of business license
5. Loan investigation (analysis) form
6. Collateral inspection form
7. Loan Agreement
8. Guarantee Agreement
9. Proof of ownership of collateral
10. Document receipt

(ShoreCap Exchange, SME Training, Manila, 2005)

Q: How is the Checklist filled in and why is this so important?

The Credit Officer must follow procedures for the checklist and "register" **every** item deposited in the file by checking the "completed" column, filling in the "date" and his/her initials in the checklist. Every document related to the client, even if it is not part of the standard checklist, must be deposited and registered in the file. If a document is not on the standard list, the name of the document is to be manually registered in the blank spaces provided at the end of checklist. Lastly and very importantly, the documents must be kept in order, as listed on the checklist, with numbers corresponding to the checklist numbers written in the upper right hand corner. The document order IS ESSENTIAL FOR EFFICIENCY.

During an audit of one MFI to verify collateral documentation, the internal auditor had to read through every single document in a client file containing four repeat loans searching for almost 30 minutes before finding the correct collateral document for the current loan. The auditor needed to audit 10 files, which took almost half the day. If everything was in the correct order and numbered, it would have taken less than one minute per file.

It is very important to make sure that ALL documentation collected by the Credit Officer, **including their notes,** are kept in the file and registered in the checklist for four reasons:

1. Credit Officers and offices are more efficient
2. The check list makes it easier for management and the Credit Committee to review
3. Consistency in record keeping for internal control purposes
4. The Credit Officer may get sick or leave, requiring another Credit Officer to take over even 'personal' notes and chicken scratch can contain important pieces of information needed later

Real Case! During a file review, the Manager noticed that much of the initial interview information, inventory count, and verification of the cashflow figures were missing from the loan file. When the Manager questioned the Credit Officer about the missing information, he showed her two drawers full of notebooks where he kept all his site visit notes. The Credit Officer took more than 5 minutes to locate the site visit notes for the client file under review. What would happen if the Credit Officer was out sick or left the MFI and another Credit Officer had to take over?

Q: How is the Checklist compiled?

By going through the step-by-step process (or a process map), each MFI will be able to determine the appropriate forms and steps needed on the checklist. The sample checklist can be used as a starting point, but the MFI will need to alter it according to its own eligibility criteria, environment, market, legal requirements, and policies regarding loan appraisal, collateral, Credit Committee, and disbursement procedures.

Q: How does the Credit Officer move a loan from the analysis stage to the approval stage?

Once the Credit Officer has a completed the Application and has performed the due diligence of the borrower by completing the Loan Appraisal and Cashflow forms, checking references, and verifying market information, the Credit Officer discusses the borrower again with his/her Manager and submits the client file to the Manager for review.

At this point, the client file should contain at least all screening and loan appraisal documentation, up to and including #21 in the checklist. This means that all the line items are checked completed, dated and initialled, the documents are filed in order behind the checklist, and documents have numbers in the upper right corner corresponding to the numbers on the checklist. This may seem fastidious, but this system makes finding documents easy for Credit Officers and a file review very quick and easy for Managers, the Credit Committee, and auditors.

If any of documents listed on the checklist are unnecessary, they should be marked "n/a" (not applicable), dated and signed. Do not leave any blank spaces.

The Manager reviews the loan application to make sure: (Ledgerwood, 2001)

- All forms are correctly completed;
- All financial computations are correct;
- All information and data gathered is consistent;
- Cashflow and repayment capacity are correct and comparable to other similar businesses;
- Loan structuring fits the business, capacity, and project;
- All signatures are valid, consistent, and correctly placed on all the forms;
- The process from loan application to credit analysis is timely; and
- All forms needed for the Credit Committee are in the client's file.

In ShoreBank's management experience, Managers reviewing or auditing files very often find that forms are missing, incorrectly completed, miscalculated, contradicting, and missing signatures. The Credit Officers must be detail-oriented and thorough in their documentation. Documentation errors can lead to losses for the MFI.

The Manager discusses the client with the Credit Officer and understands the client, project, business, loan appraisal and cashflow details, as well as the Credit Officer's opinion. The Manager then questions and probes the Credit Officer for unverified, incomprehensible, missing, or incomplete information. Also, the Manager may recommend alternative loan structuring and collateral combinations with the Credit Officer.

Based on the Manager's review, discussions with the Credit Officer and the final loan structuring, the Manager can do one of three things:

1. **Send the loan to the Credit Committee:** If the loan application is complete and ready for the Credit Committee, the Manager initials the review line and submits the loan file to the Credit Committee.

2. **Ask the Credit Officer to collect additional information or missing documentation**: The Manager requests the Credit Officer to complete the information needed and / or re-verify inconsistent information. The loan will be deferred until the Credit Officer completes the loan application to the Manager's satisfaction. Only then will it go to Credit Committee. Thus, after the Credit Officer has fulfilled the Manager's requests, the loan goes back to the Manager for another review before going to committee.

3. **Reject the loan applicant:** If the Credit Officer and Manager find the applicant is not creditworthy, the request is denied and a written decline letter with the specific reason is sent to the client. A copy of the letter is filed in the client file. The Manager and Credit Officer sign off on the checklist that the client has been rejected and the date.

Some MFIs do not allow the Credit Officer or Manager to reject any loans after the application stage. They want all loans to go through the Credit Committee. The purpose of this is to give every client a chance to be heard by the Credit Committee, as well as for internal control purposes (to stop clients from having to pay to get their loans through to Credit Committee *).

Sending every loan application through to Credit Committee is very inefficient and the Manager should be able to reject a loan before the Credit Committee, based on criteria set out by the MFI, such as poor credit history, inadequate cashflow, and lack of guarantors and/or collateral. The MFI should track the level of rejections after application to see if too many clients are making it through the screening and then being rejected before Credit Committee (over 20% would be too many). If this is happening, then the quality and level of screening is not adequate and should be improved. If the Credit Officer feels that the rejection is not substantiated, s/he should be able to present his/her case to the Credit Committee or have some sort of recourse.

* Equity Building Society in Kenya has set up a Fraud Hotline to help with internal controls. Clients, who feel that they have not been treated fairly or have had to pay some unofficial payment to receive a loan, are able to lodge their complaints anonymously.

Q: What is the Credit Committee and who is on it?

The last stage in the due diligence process is the Credit Committee, where the decision is made to approve, reject or defer the loan request. This is the time to review the Credit Officer's analysis and give feedback to him/her. The Credit Committee not only reviews loans, but also serves as a regular review of the loan products and their performance (Ledgerwood, 2001).

The Credit Committee is therefore an important aspect of the loan process because it allows not only a thorough review of all loan applications, but also a regular evaluation of the individual lending products' performance. The following guidelines aim to standardize the conduct of Credit Committee meetings.

The Credit Committee can take on a few different forms:

1. It can be made up of several Managers, who sit together and discuss loans and who have authorization to approve loans up to a certain limit (recommended).
2. Several Managers who review the loan individually, give their decision and then pass it on to the next Manager for review.
3. In some MFIs, the Credit Committee can be a single person.

We recommend that MFIs have a "Committee" that sits together and discusses the loans. One purpose of this type of Credit Committee is to provide a setting where loans are presented and can be discussed, questions answered and feedback given on the analysis and risks presented. Credit Officers learn new skills and what to expect by having a "live" Credit Committee. In this option (#1 above), the Credit Committee should be made up of 3–5 members to keep the decisions quick, yet give good feedback and analysis. The Credit Committee usually has various members for increasing levels of authority. In the case of larger loans, the loan may be approved at the branch level and then sent to a Head Office Credit Committee, also made up of 3–5 members, for final approval.

Example of Level of Approval Authorities of a MFI in the Caucasus:

Credit Officers – present at committee
Branch Manager – up to $5,000 with at least 2 Credit Officers
Head of Credit – up to $15,000 with Branch Manager and 2 Credit Officers
Chief Financial Officer – up to $15,000 with 2 of the above
Chief Executive Officer – up to $20,000 with 3 of the above

All loans must have at least 3 persons who authorize approval in a Credit Committee setting (option #1 above). All loans over $20,000 must be approved by the Board.

For another example of Level of Approval Authority see *Credit Manager's Toolkit, Session 11 Part 2***.**

Q: When does the Credit Committee meet?

The Credit Committee meets on an "as needed" basis, according to the quantity of loans produced (weekly, biweekly, or daily) to ensure efficiency and a fast response to clients. The Committee should be scheduled in advance, in order to allow members to plan their week.

Q: What needs to be submitted to the Credit Committee and when?

Completed loan files must be submitted to Committee at least one day in advance and include all documents up to Manager's review on the checklist. This includes:

	Item
1.	Screening Form *
2.	Information Session Completed
3.	Loan Application Form *
4.	Passport Copy, MFI I.D. *
5.	Photo collected *
6.	Business Charter, Registration and License(s) copies
7.	Supervisor signature (proceed or reject) *
8.	Real Estate Assessor's (Credit Officer) valuation of collateral *
9.	Written Verification of Credit History
10.	Bank account statements for last 6 months
11.	Quotes from suppliers for equipment and supplies
12.	Contracts with main suppliers copies
13.	Contracts with main customers copies
14.	Verification of items to be purchased with loan *
15.	3 Reference checks of Borrower * (customers/suppliers/neighbours/ competitors)
16.	Loan Appraisal Form Completed *
17.	Cashflow form completed *
18.	Inventory form completed *
19.	Ownership papers for equipment
20.	Ownership papers for bus. premises or Rental Agreement
21.	Ownership papers for other collateral, specify: _____________
22.	Program Manager's agrees to send to Credit Committee *

The items which would be required as a bare minimum are starred (*) above.

A Summary Sheet of all the loans to be reviewed is compiled from the loan files submitted and signed off on by the Manager. Loans submitted late will be included in the next meeting of the Credit Committee.

Q: Are there any general rules for the Credit Committee?

General rules that the Credit Committee should follow are:

- Appoint a chairperson to facilitate
- Limit the number of loans to review in one session
- One meeting should not be more than two hours
- All write-ups on loan applicants are to be received in advance
- Start and end meeting on time
- Set time limit expectation for presentations – five minutes
- Standardize Credit Officers' presentations
- If the Credit Officer is not prepared, defer the loan to the next meeting when the Credit Officer is prepared

- Save all Q&A until after the presentation
- Limit Q&A session for each loan – ten minutes
- Chairperson records outcome of CC and all members sign – approve, defer, or reject with comments

Thus, in a two hour period, the Credit Committee can review eight loans if each loan review is not more than 15 minutes. If there are additional loans to be reviewed, they take a break and come back. Over two hours of reviewing loans is too much time to retain focus.

Q: What does the Credit Committee consider to be important?

The Credit Committee will pay particular attention to the following in considering loan applications (Ledgerwood, 2001):

- The Individual: Review the applicant's past credit history, business performance, management skills, and standing in the community. The applicant must, of course, meet the established eligibility criteria. Fit with the business is also critical, as discussed earlier.

- The Financial Position: How has the business/person performed financially? Does the balance sheet demonstrate a good grasp of managing resources and controlling debt? Is the business growing, with a strong market potential? Are there risks to the business (supplies/sales)?

- Repayment Capacity: Is the revenue currently generated by the business and family sufficient to meet expenses, inclusive of the monthly/weekly loan payment? Are there risks that might affect the client's repayment capacity (single parent, illness, sole income source for the family)?

Q: What should a Credit Officer do for the presentation to the Credit Committee?

The Credit Officer's presentation should only be five minutes. It should present all the information below in an orderly, clear, and concise manner, according to the MFI's presentation guidelines. The Credit Officer will need to know all the information or copy the necessary documents before his/her presentation as the Credit Committee may be looking through the file during the presentation.

The presentation of a loan applicant by the Credit Officer should include the following (Ledgerwood, 2001):

1. Client's personal and family information:
- name
- age
- number of dependents
- number of years in the community
- other sources of family income

2. Kind of business and location of operation.

3. A general description of the business:
- age of business (must be at least _______)
- applicant's length of experience in that trade (must be at least ________)
- products made and/or services rendered
- frequency of purchases and sales
- total values of purchases and sales
- who runs the business when the client is sick or away

4. Principal financial indicators:
- Total net worth, including total assets and liabilities (level of indebtedness)
- Total net income after servicing existing debts, including net business income and net household income
- Results of cashflow and repayment capacity analysis
- Other indicators, including any risks to supplies, production, sales, household and other factors

5. Other Loan Appraisal results:
- Credit history - borrowing and paying habits
- Savings history and practices, including the total amount of current bank savings and verified savings at home
- Previous dealings with creditors and suppliers
- Payment records
- Character of the applicant as perceived by the references
- SWOT Analysis, Risks and Mitigating factors

5. Conclusion and Recommendation. The Credit Officer should present the loan structure, which must be consistent with the client's cashflow:
- amount of loan
- duration of loan
- frequency of payment
- amount of instalment payment
- conditions of disbursement, including collateral required

Q: How does the Credit Committee make loan decisions?

After the presentation and discussion session, the chairman summarizes the loan application and a vote is taken. The Credit Committee can make decisions either by a majority vote or reaching a consensus, according to the MFI's policies. Decisions should rarely be made by one member and/or "influenced" by one member (i.e., chairman or most senior staff person).

Q: What decisions can the Credit Committee make?

The Credit Committee has four decision options:

1. **Approve with existing structuring and conditions**
2. **Approve with alternate structuring and conditions**
3. **Defer**
4. **Reject**

These options are discussed in detail below.

Q: How and where are the decisions recorded?

Votes are recorded in the client's file, as well as in a Credit Committee summary sheet. This creates a double check for decision verification, if needed later. The chairman summarizes committee decisions and then all members sign in agreement.

> It is important to keep a separate record of the Credit Committee's decision which is recorded by the chairman and locked in a file cabinet. Loan files are known to be doctored (loan, amount, term and/or frequency, changed).

Q: What happens if the loan is deferred?

If the loan is deferred, the loan file is returned to the Credit Officer in order for him/her to collect and verify additional information required and/or to discuss a possible new loan structure suggested by the Credit Committee. The committee should write the specific points required. Upon completion, the Credit Officer can resubmit the loan applicant to the Manager for review to make sure that everything has been completed as required by the Credit Committee. If it is done satisfactorily, the loan is resubmitted at the next Credit Committee meeting.

> Through the loan deferment process, the Credit Officer should learn to not repeat the same mistake twice. If there are repeated mistakes by the same Credit Officer, the Manager needs to address this problem as s/he is wasting Credit Committee's time.

Q: What happens if the loan is rejected?

Notifying a client that his/her loan has been rejected is one of the most difficult duties of a Credit Officer. The Credit Officer must find a way to be diplomatic so that the client does not tarnish the MFI's reputation. S/he can give a sense to the client if there is any hope to reapply when certain criteria have been met or if there is an alternative financial institution that would be more suitable for the client. However, the Credit Officer should not give false hopes.

If the loan is rejected, a record is made in the loan file and on a Credit Committee summary. The Credit Officer must prepare a loan disapproved letter, detailing the reason for the rejection and if there is anything the client can do in the future to change the decision, such as increase the owner's contribution by starting a savings account. The Credit Officer should have the letter signed by the Manager and give a copy to the client. A copy of this should be registered and filed in the client file.

Q: What happens upon approval of a loan?

Informing the client as soon as possible is important so that the client can get started fulfilling the conditions of disbursement and collateral requirements.

After the Credit Committee members have completed and signed Part E: Approval of the Loan Appraisal, the Credit Officer informs the client in writing of the approval decision, loan terms and any conditions that the client needs to fulfil before disbursement. A copy of the written letter to the client, approval, deferment or rejection, must also be filed in the client's file.

Q: How does the Credit Officer close the loan upon approval?

The closing of a loan is the most important step to securing a loan and making sure the MFI has a solid case if the client has to be brought to court. The collateral needs to be perfected. Many banks and MFIs employ a specific person or even a lawyer to review the documentation before the loan is disbursed to make sure everything is exactly according to the local laws.

An Alternative Method of Documentation Verification

All completed documents are sent by courier to the Loan Administration Department at BRAC Bank Limited head office, except the monthly post-dated cheques. The Loan Administration Department then checks the documents for completeness. The Credit Officer is informed via SMS of any missing information or documents. As soon as Loan Administration Department is satisfied with the submitted documents, Credit Officers are notified by SMS and a disbursement request is prepared. Repayment schedules are then prepared by Loan Administration Department and are sent to the Credit Officer. Loan funds are then credited to the client's account.

After the client has fulfilled all of his/her obligations, the client should come to the MFI office with his/her photo identification card and guarantors. Before the client signs any of the documents, the Credit Officer or Manager discusses, and makes sure the client understands, the loan terms, obligations and importance of repayment with the client. The Credit Officer also lets the client read each document and then the Credit Officer reviews the details of each document with the client. The guarantors are also informed of their obligations under the loan before signing the contracts. Guarantors are usually met by the Credit Officer prior to this, as the Credit Officer must verify their existence, employment and wages.

The client signs each document in the presence of the Manager. The Credit Officer ensures that everything has been completed, including all documents registered in the checklist and documents filed.

Q: How is the loan disbursed?

Disbursement is the last stage for catching any mistakes before the loan goes out the door. Make sure that at least one detail-oriented, objective person, other than the Credit Officer, thoroughly checks the whole file.

Then the Manager reviews the file from top to bottom to make sure all documents are in the file, the Committee decision agrees with the loan terms of disbursement, the contracts and documents are correctly signed and the loan conditions are fulfilled according to the Credit Committee's decision. If everything is in order, the Manager signs the file, contracts, necessary documents and the disbursement request form or cashier's check according to the MFI's disbursement policies and processes. The disbursement request or check should be less any upfront fees, notary fees, insurance or other deductions according to the MFIs policies.

At this point, many MFIs employ a lawyer, especially for larger loans, to review the documentation before the loan is disbursed to make sure everything is prepared exactly according to the local laws.

Next, the file is sent to the Loan Administrator, who thoroughly rechecks the file, enters the loan into the MIS, and signs off. If everything is done properly, s/he signs as the second signature on the form or check. The form or check is submitted to the teller, who transfers the funds to the client's account. The client accesses their funds through their account. A copy of all contracts and documents is filed in the client file and given to the client for their records.

Disbursement through bank accounts, not necessarily your own …

Disbursements of loan proceeds are made to the bank account of the borrower that s/he has requested to open and maintain for the duration of the loan. BRAC Bank Ltd. established agreements with a number of commercial banks with a wider network of branches so that loan proceeds can be disbursed and repaid through a bank account convenient to the borrower. The bank's limited branch network did not prevent it from servicing their remote customers. The bank effectively tapped and utilized resources of other banks to serve the needs of their customers. This arrangement is cost effective and will continue until the volume of business in a particular area can justify the setting up of its own branch.

The client file is sent to the Loan Administrator for filing in a locked, fire proof loan file cabinet. It is recommended that MFIs keep original contracts and collateral documents in a fire proof safe and copies in the file. There should be limited staff access to client files and a system of signing the files in and out.

It is extremely important that there are specific steps set out by the MFI to process loans efficiently and according to a standard policy. This should include a series of checks and balances of staff preparing analysis, verifying documentation, approving loans, and signing agreements and cash disbursement receipts. Above is an outline of the suggested steps. These should be altered for your MFI's particular situation.

Keep in mind when designing the steps to the lending process, including screening, loan appraisal, approval and disbursement, that there should be a balance between controlling the process, efficiency and timeliness. Too many steps, documentation and controls can add significant time delays to the process.

Bank Rakyat Indonesia's Disbursement Process

Based on the documents signifying official approval of the loan request, the Deskman begins the disbursement process by entering the relevant data in a Loan Application Receiving & Processing register. Then s/he prepares the Loan Agreement and completes a Cash Receipt form. Where collateral (i.e. for loans above $300) is required, the Deskman also prepares the mortgage documents. The borrower is then asked to come to the unit office to sign the loan agreement and the cash receipt form. Spouses are required to sign the loan agreement as co-borrowers. All completed pre-disbursement documents are then submitted to the unit Manager who verifies their completeness and signs his/her approval. The loan agreement and mortgage documents are returned to the Deskman for data entry into the MIS and filing. The Cash Receipt form is given to the teller who then disburses the loan funds to the borrower.

All loan documents are kept by the Deskman in the unit office. The Deskman and the unit Manager are equally responsible for the completeness of the credit documents on file and no document may be released or withdrawn from the files without the approval of the unit Manager.

(ShoreCap Exchange, Micro and SME Training, Manila, 2005.)

Important Note: If a loan disbursement is not handled properly, conditions are not met by the client, or MFI policies are not followed, there can be serious future consequences. For example, the client may not have contributed their funds and so the total loan amount for the project will not be enough. Similarly, if collateral was not perfected, the MFI may not be secured. Finally, if the cash receipt was not signed by the borrower, there is no written record of the borrower receiving the funds, which leaves the MFI at risk.

Red Flags:

- Following the checklist procedures is essential and efficient.
- Don't get caught without proper documentation. Make sure that all documents are filed properly and registered in the checklist. Missing documentation becomes a problem only when you need it. For example, when the loan becomes a problem or the Credit Officer leaves.
- All client files and Credit Committee decisions should be kept in a locked cabinet and only accessible to persons who need the files (i.e. Credit Officer, Managers, Loan A, managers, loan administrators, etc.).
- All original contracts and collateral should be securely kept in a fire proof safe.
- The Credit Committee should follow specific procedures, which make their job more efficient.
- Disbursement is tedious, but must be done exactly and correctly.

Session 10: Collection, Monitoring and Problem Asset Management from a Loan Officer's Perspective

Q: Why do Credit Officers need to monitor regularly?

Credit Officers need to monitor regularly to:

- Remind clients of repayments that are coming due
- Keep an eye on the clients
- Understand the client's business development
- Catch problems early
- Document information in the file
- Marketing
- Build the client relationship
- Establish trust
- Give advice (not too much!)
- Allow Managers to review portfolio information

In summary, Credit Officers should monitor for five reasons:

1. To let the customer know that the MFI is taking an interest in their business. The customer should understand that repayment is important to the MFI. The relationship should be supportive; it is in the interest of both the customer and the MFI that the business should develop successfully.

2. To catch any potential problem early. Why?

- In case there is still time to try and work out the situation.
- The MFI can act before collateral disappears.

3. To document information gained and update the credit file. Why– why?

- Recording the date of the visit helps to ensure the next visit will be made at the necessary time.
- Good records aid quick decisions in the future.
- To help your replacement quickly understand the entire history of the loan and easily continue the relationship with the customer, if you leave your position, for whatever reason.

4. To conduct marketing efforts; finding other customers through current clients and building a good name for the MFI.

5. To build a relationship of trust and honesty with the client. A good relationship can help bring in new clients (through friends of the client), encourage repeat loans, encourage the client to repay on time and enable the Credit Officer to better detect if something is wrong before a loan becomes delinquent.

Q: When do Credit Officers monitor and how often?

BRAC Bank Ltd.'s (BBL) Account Monitoring Policy

Account monitoring is one of the most important responsibilities of the Credit Officer. As per the policy, all existing accounts must be monitored at least once a month. Accounts with overdue instalments require more frequent visits and increased pressure.

The ability to effectively monitor repayment performance of accounts depends, to a large extent, on the quality of MIS. BBL's small loan portfolio MIS is adequate in terms of providing accurate and timely information on account repayment behaviour. It has also been able to address the communication infrastructure shortcomings by adapting radio link technology where cable facilities are non-existent or inadequate.

The monitoring schedule for each client will vary slightly according to the business and key risk events. In general, a new loan should be monitored to verify the use of loan proceeds, before the first repayment, every quarter (as long as the repayments are on time), and then two weeks before final repayment. A trusted client with more than two loan cycles repaid, completely and on time, should be monitored to verify the use of loan proceeds, then every six months, and finally two weeks before final repayment. Some MFIs require monthly monitoring for the life of the loan or, at a minimum, for the first six months of the loan.

Using the loan funds according to the project is the first critical step in making sure the client spends the funds as planned and is therefore able to repay the loan. Credit Officers should always monitor this phase of the loan.

There is always a very real risk that the client may divert the loan funds to other needs (personal or even another business). Not using loan proceeds according to the loan appraisal plan is the first warning sign of a potential problem loan and control point for the loan. If all the loan proceeds do not go into the business, all the planned cash will not come out of the business to repay the loan.

More frequent monitoring is advised in the case of high risk loans such as start ups, restructured loans, problem loans, or very large loans. For example, if the business is involved in construction, importing of goods and/or equipment, or has high receivables, it should be monitored more closely.

The Credit Officer should also schedule visits when certain key risk events occur. For example, the Credit Officer may be aware when the loan is made that a very large supplier contract will end in a certain month. Thus, the Credit Officer should verify with the company that the contract was renewed or that they have obtained another supplier contract.

VITAL TIP: Credit Officers should always visit delinquent clients within one day of repayment delay. This also applies to repeat clients, even if the client has, in the past, paid on time. It is a fact that the more quickly a Credit Officer follows up on a delinquent loan, the more likely loan recovery is.

Effective MIS and Monitoring Policy:

Overall, Association of Cambodian Local Economic Development Agencies (ACLEDA) practices zero-tolerance on default. Meaning, as much as possible, a loan should never be in default. ACLEDA has an effective MIS that monitors the status of all loans and their account history. The bank has invested in a loan portfolio MIS which can provide up-to-date, accurate and timely information on the entire consolidated loan portfolio on a daily basis. This has contributed to minimal defaults because delinquencies and problems can be identified and pursued almost immediately. Furthermore, the bank's credit personnel have been trained to emphasize strict credit discipline among its borrowers at all stages of the credit process. As of June 2005, its portfolio at risk was measured at less than 1%.

As per the policy, several measures have been implemented to mitigate risks of delinquent or problem loans. First, at all stages of the lending process, the borrower is constantly reminded by the Credit Officer of their responsibilities as borrowers, the repayment schedule and penalties for late payments. Secondly, the bank has installed computers in all branches with the current MIS that is able to monitor all loan accounts and provide management with real-time client account information.

Monitoring Reports:
As part of the monitoring activities of ACLEDA, daily reports are produced for all staff in credit administration. These reports include the following MIS reports:

1. Loan Portfolio Quality by Credit Officer Report
2. Payment in Arrears Report
3. Aging of Loan Report
4. Portfolio at Risk Report

The reports are consolidated for the whole agency and reproduced daily, weekly and monthly. They are shared with the Bank's Senior Management, Credit Department and Branch Management.

Nevertheless, loan monitoring is still the responsibility of the Credit Officer. In the case of non-payment, s/he is required to monitor the borrowers the day after any delinquency occurs.

(ShoreCap Exchange, Micro and SME Training, Manila, 2005.)

Regular monitoring is the key to maintaining a healthy portfolio and can save time in the long run. It helps to know your client, in case a loan goes bad, so that you can try to work with him/her to solve the problem together. Very often monitoring is forgotten or not done. It is the step that very often receives the lowest priority for Credit Officers. They tend to focus on new deals and building their portfolio, not maintaining a healthy portfolio, until it is too late. Credit Officers must find a delicate balance between the two duties, building and maintaining a healthy portfolio.

Managers also need to monitor clients and audit files. This is described in great detail in the *Manager's Toolkit, Session 12*.

Bank Rakyat Indonesia's Alternative Monitoring Method:

Monitoring of the repayment performance of micro loan borrowers is the responsibility of the credit office and the entire unit office. Credit Officers are not required to follow a set number of periodic and regular visits to clients. Instead, they meet with the borrower to discuss the business developments when the borrower comes to the unit office to make a repayment (usually monthly). The Credit Officer is however required to visit the borrower when there are delays in repayments. Managing arrears is a principal responsibility of the Credit Officer and ultimately reflects on the overall performance of the unit Manager.

In lieu of individual account monitoring, Bank Rakyat Indonesia monitors the performance of each Unit office in accordance with set guidelines. A branch manger must visit at least 1 unit office each month (an average branch normally supervises about 10 to 12 unit offices). The Deputy Branch Manager for Micro business is required to visit each unit office under his supervision at least twice a year. The Assistant Micro Business Manager must visit each unit office at least four times a year. In addition to these, the internal controller completes a more comprehensive review of the entire operation of a unit office on a regular basis. He normally visits the unit office for a week, at least once a year.

Q: How does the Credit Officer know/remember when to monitor?

To ensure the appropriate scheduling of monitoring for each client, monitoring should be scheduled at the time of loan disbursement by the Credit Officer and Manager. The monitoring schedule should be documented at the bottom of the File Cover Sheet/Closing Checklist. This schedule should then be entered into the Credit Officer's personal daily planner. All Credit Officers should use a daily planner to keep track of important information, including the following: (1) when monitoring visits are scheduled; (2) when clients are due to make their final repayment and may need a subsequent loan; and (3) deadlines for delinquent borrowers. The planner helps a Credit Officer to organize him/herself. To make sure that each Credit Officer and Manager has a daily planner, the MFI should provide one for each person.

Association of Cambodian Local Economic Development Agencies Work Plan

The Credit Officer is expected to prepare a two-week work plan for submission to the Chief of Credit Officer or Branch Manager. Included in this work plan are lists of new prospects to be visited, approved loans and disbursements to be made, problem accounts, and the Credit Officer's accounts with repayment due. Individual reports summarizing their actual achievements are then submitted to the Chief of Credit Officer, Branch Manager and Head Office, after the completion of the activities. These relatively simple enhancements have helped Credit Officers to better organise and manage their work, as well as for management to supervise them more diligently.

(ShoreCap Exchange, Micro and SME Training, Manila, 2005.)

Q: What do you do on a monitoring visit?

Generally, it is the Credit Officer who does the monitoring. In some rare cases, MFIs (more often banks) have monitoring or loan servicing departments, which take over the loans after they are disbursed. They have a team of Credit Officers, who originate the loan before handing it over to a monitoring department. In general, it is preferable at this level of loans that the Credit Officer handles the loan origination and monitoring.

The Credit Officer or monitor should:

1. Be open and talk to the client to find out about his/her current situation. This is required so that the client feels comfortable with the Credit Officer and can let them know the real situation. The Credit Officer should not just bury their heads in their monitoring form.
2. Complete the monitoring form (details to be gone through later)
    a. Collect current financial information
    b. Compare reality with your original analysis
    c. Ask additional probing questions
3. Watch for warning signs and observe the workplace for changes, either for better or worse (details to be gone through later in this session)
4. Market the MFI/sell your next loan. This is important as it is much easier to analyse and disburse subsequent loans than to get the first loan. Clients with repeat loans are usually better payers, improving the quality of your and the MFI's portfolio. (Careful: sometimes repeat clients receive loans that are too large and therefore cannot make the repayments.)

Q: What are the most important factors to monitor?

The most important factors to monitor are the **changes** in (Pikholz, 2001):

1. Physical look of shop, raw materials, employees, etc.
2. Sales trends and inventory levels, accounts receivables and payables (if applicable)
3. Overall cashflow (sales and expenses) compared to analysis
4. Assets and liabilities
5. Major sums in or out of the business – purchases/sales
6. Major increases/decreases in receivables, payables or inventory
7. Competition
8. Suppliers and customers
9. Collateral condition

It is extremely important that a Credit Officer knows the business well enough to notice changes occurring, such as a new employee, equipment missing, new equipment, paint peeling from a wall where a roof is leaking, etc. S/he must notice these little nuances that could indicate forthcoming problems.

These will be described in detail later under the monitoring tool section.

Q: Does the Credit Officer need to document the monitoring visit?

Absolutely! It is essential that the Credit Officer and Manager document every visit and discussion they have had with the client. The Credit Officer should complete a Monitoring Tool form to document the visit and current situation of the borrower. The purpose of this is to ensure that anyone picking up the file can understand the current situation of the client.

Monitoring Tool

Loan #		Borrower's Name		Amount of Loan	
Branch		Business' Name		% rate / Term of Loan	

		Visit #:						
		Date:						
1.	Borrower present at visit?		Yes / No		Yes / No		Yes / No	
		Cashflow Loan Appraisal	**Projected**	**Ratio (Real / Projected)**	**Projected**	**Ratio (R / P)**	**Projected**	**Ratio (R / P)**
2.	Monthly Sales (Cash in)							
3.	Monthly Expenses (Cash Out)							
4.	Monthly Operational Cash(3 – 4)							
5.	Actual Cash in hand							
6.	Quality of Financial Reporting							
7.	Scheduled Outstanding Balance of Loan							
8.	Amount in Arrears / Overdue days:							
9.	Relationship with Suppliers							
10.	Relationship with Customers							
11.	Competition (changes?)							
12.	Expenditures incurred which are NOT part of the project							
13.	Risk Grade							
14.	Follow-up needed		Yes / No		Yes / No		Yes / No	

Visit Results/Comments: Have the disbursement conditions been met? How? Are there any significant changes in the business such as new competitors, customers, suppliers, and/or capital expenditures; premises conditions altered; COGS changes; sales price changes; marketing changes; change in sales volume? (Use back of form if necessary.)

Comments from visit 1:

Comments from visit 2:

Comments from visit 3:

ADDITIONAL MONITORING VISITS:

Comments:
Date:____________________

Comments:
Date:____________________

Comments:
Date:____________________

The Monitoring Tool is used to document the visits made to the client during the loan repayment. Each visit should be recorded on the form.

Q: What are some of the warning signs of a faltering business?

The Credit Officer should look for changes in the business and environment. It is not important what the change is, positive or negative, but it is important for the Credit Officer to find out why the change has occurred.

Certain *changes* in the business (both positive and negative) can mean bad business. The **Credit Officer** should keep an eye out for:

Collection

- Are payments slow?
- Does the borrower return calls?
- Does the borrower give specific information about the situation?
- Are promises to pay kept?

Financial and business data

- Can you get financial information?
- Changes in sales trends
- Changes in gross margin trends
- Cashflow compared to projections?
- Inventory growing compared to sales?
- Who does the business owe? When is/was it due?
- Any salaries or taxes "deferred"?
- Funds being lent to projects or persons outside of this business?
- Changes in assets and liabilities **-** major sums in or out of the business – purchases/sales
- Major changes in receivables and / or payables
- Major changes in inventory
- Changes in competition
- Changes in suppliers and buyers

Attitude

- Avoiding your calls?
- Not able to acknowledge problems
- Anger at MFI for collecting
- Is substance abuse or addictive behaviour evident?
- Is the owner there **-** physically? Psychologically?

Business plan / project

- Project not working
- Borrower has changed project
- Borrower doesn't know/understand his/her cashflow
- Business appears disorganized (risks: hidden losses, quality control difficult to maintain)

General economic conditions

- Is there a "recession"?
- Is there a problem in this industry?

Personal Problems

- Personal problems taxing capacity to function
- Personal problems draining funds
- Family situation draining funds

Final Step: Assessing loan quality/risk

- Is the collateral still there? Can it be moved?
- Do you still trust this person? ("gut" feeling)
- Is the problem temporary? Really?
- Can the borrower solve the problem with current resources (money and talent)?
- Is the loan file in good shape; i.e., documentation complete and correct?

The Credit Officer must know the business, notice details and ask questions about the situation. Even positive changes in the business can be warning signs for repayment. For example, an increase in assets could be positive for the business, but may prevent repayment. An increase in inventory could mean the owner has a new partner with whom s/he must split the profits.

Q: What are alternative ways to monitor?

In *MicroSave*'s and ShoreBank's experience, there have been several examples of monitoring alternatives, which do not involve visiting the business regularly (saving time for the Credit Officer). Although these have worked for some MFIs in various countries, they may or may not be appropriate in your culture. A MFI must test these before fully employing. The safest way to establish a good customer base and healthy portfolio is to be more conservative in the beginning by performing on-site monitoring and then later to become more lenient once the credit culture has been established and the individual lending product is working well. The alternative methods have included:

- Exception Monitoring – MFIs try to cut cost by cutting corners on monitoring. Thus, they only monitor when a client is late. In some cultures where the overall repayment rates are very high (e.g. Bosnia), this works very well. In a culture where overall repayments rates are lower, this method is not appropriate. In general, this method is not recommended.

- "Watch List" Monitoring – Through analysing trends in the portfolio arrears and creating a "Watch List" Report, which identifies key problem areas, MFIs are able to post warnings for staff about endemic problems within the institution. The "Watch List" is then circulated throughout the MFI. This allows the Credit Officers and management to be on the lookout for the "Watch List" problems. For example, a "Watch List" could be comprised of the following problems:

a. Over-financing of loan proposal
b. Diversion of funds
c. Business related to the poultry industry due to the bird flu
d. Increased business competition
e. Too many debts of the borrowers
f. Borrowers are not the real owners of the collateral offered

(ShoreCap Exchange, Micro and SME Training, Manila, 2005)

- SMS reminders (CI) – SMS reminders are sent to the client on the day before repayment is due. This method is used to encourage good repayment without expensive on-site visits.

- MIS Monitoring (ACLEDA) - Credit Officers monitor clients extensively through several reports generated by its MIS. Some of the reports are as follows:
    - Loans Outstanding classified by amount
    - Percentage of Outstanding and PAR by Sector
    - Loans Outstanding by Gender
    - Loans Outstanding by Balloon
    - Loans Outstanding by Loan Products
    - Portfolio Concentration
    - Loans Outstanding - Actual vs. Planned

Although at most MFIs these reports are used by Managers, at ACLEDA, Credit Officers are able to gain key information about high risk businesses and risks within their own portfolio by having access and using these reports. Then they make monitoring decisions based on these reports. For, example, if loans with balloon payments are showing an increase in delinquencies, then the Credit Officer may want to make a visit to these clients to inspect the situation. This is in addition to monitoring of delinquent accounts more than one day overdue.

A MFI in India had to contend with poor and inadequate telecommunications infrastructure, which hampered the smooth delivery of services to their customers. The MFI successfully adapted SMS facilities to facilitate communications and ensure that service delivery standards are maintained, even at remote locations. It will be introducing further improvements in voice and data transmissions through radio links in areas where cable facilities are still inadequate. The availability of up-to-date and accurate information at all times is crucial to effective account monitoring.

* Receiving current account delinquency information from a reliable loan portfolio MIS and being able to pursue clients immediately, is a critical factor in keeping overdue loans at manageable levels.

(ShoreCap Exchange, Case Study, Manila Training, September 2005)

Q: How does an MFI cope with problem loans?

Many MFIs use their Credit Committees at the branch levels to discuss problem loans. Other MFIs have developed a special Problem Loan Committee to discuss strategies to deal with loans that are more than 120 days overdue. Some policies regarding the Problem Loan Committee could include:

- The Problem Loan Committee would be comprised of at least one senior staff member from Operations, Internal Audit, and Finance departments.
- The committee should meet at least once per month.
- Agenda items could include:
- Review of PAR Reports and Credit Risk Reports for the entire portfolio, including trend reports looking for changes
- Review of findings and recommendations of branch review
- Required deadlines and disciplinary actions necessary

- Recommendations to senior management required changes to policy, procedures and credit methodology

Another method for collections would be to create a Collection Department. Collection officers would solely work out serious problem loans and allow the Credit Officer to concentrate on building business and relationships. By passing the loan to a higher authority, this lets the client know that the bank is serious and will fight until the end to recover the loan.

Collections Department Example in a MFI:

After a period of 120 days, the Credit Officer turns the delinquent loan over to a collection department. When this happens, the loan is reassigned from the Credit Officer to the Collection Officer, although the loan is still accounted for in the Credit Officer's portfolio. The Credit Officer is driven by the total number and amount of loans in his/her portfolio and PAR so this will continue to be a loss for him/her. The Collections Officer is driven by the amount of loans s/he recovers. Additionally, the Collections Department is required to provide support in the management of delinquent loans that are less than 120 days in arrears.

For more information on incentives refer to the ***MicroSave* Staff Incentive Toolkit**.

Q: How does delinquency impact the MFI?

Delinquency impacts the MFI's sustainability, directly and indirectly.

The direct costs of delinquency have an impact on sustainability in the following ways:

- There is cash shortfall at the branch. If a MFI does not have enough cash inflows from loan repayments, there many not be enough funds to make new loans and it will not be able to serve its target market.
- To make up for the shortfall in cash as a result of delinquency, the cost of funds increases because the branch now has to borrow money from the head-office or from the private sector
- Interest income is forgone (although the MFI may collect penalties)
- A potential loss of savings deposits
- An increase in loan loss reserve and additional loan loss provision

The indirect costs of delinquency have an impact on sustainability in the following ways:

- The Loan Officer's time is spent on following up on past-dues
- The Loan Officer's time is taken away from developing new business
- The Head-Office, Regional and Branch Managers' time is spent on addressing problem loans
- A decrease in motivation of staff
- A decrease in motivation of other borrowers to pay on time
- A loss of reputation
- An inability to raise capital from the private sector in the future

Cost of a write off:

Facts about the MFI as of March 31, 2004:

- ✓ 2.0% interest per month on a declining balance
- ✓ Portfolio outstanding = $1,250,023
- ✓ 19% of the loans did not make a payment this month
- ✓ $5000 loan was written off in March

Questions and Answers:

1. How much interest should have the MFI collected in March 2004?

Answer: 2.0% x $1,250,023 = $25,000.46

2. How much interest did the MFI collect in March 2004?

Answer: 2.0% x (1-19%) x $1,250,023 = $20,250.37

3. What rate of interest did the MFI actually receive in March 2004?

Answer: $20,250.37 / $1,250,023 = 1.62%

4. How many loans of $5000 for 12 months must the MFI make to recoup the $5000 written off? (Hint: $5000 loan at 2.5% interest declining earns $670.72 per year)

Answer: $5,000 / 670.72 = 7.45 loans **(or one month of a Credit Officer's time at 8 loans per month!)**

Q: What are the causes of delinquency?

Two of the most common causes of delinquency are: (1) granting too large of a loan and (2) diverting loan proceeds away from the planned project.

Closer attention must be paid to the MFI's design of the lending product and inefficient methods of collections. Most widespread, high levels of delinquency within an institution are a result of internal MFI products, policies and procedures that are not consistent with clients' needs.

EXAMPLE FROM AN MFI IN SOUTH ASIA:

A recent review of about 140 non-performing larger micro loans at this MFI in South Asia revealed that giving borrowers more than what was necessary was one of the major causes of their poor repayments. Over-financing often leads to misuse of funds and subsequently to an inability to generate enough cash to repay the obligation. The MFI realized that it needed to develop appropriate quantitative tools, which will enable it to have a more accurate assessment of financing needs and thus aid in proper loan structuring. For example, the tools could help determine ideal loan amounts, the right tenor and properly considered repayment modes.

The MFI management wrote: "Credit Officers are crucial to the continued growth of the micro loan portfolio. They are generally responsible for (a) marketing loans, (b) assisting borrowers in complying and completing basic pre-approval documentary requirements, (c) evaluating the credit request and preparing the appropriate recommendations, (d) monitoring repayments, and (e) collecting overdue instalments. Credit Officers, with the assistance of Regional Managers, currently handle problem loans. The MFI intends to create a Loan Recovery Unit staffed by loan recovery specialists so that Credit Officers can continue to focus on portfolio build-up. As part of loan monitoring procedures, all existing and good accounts need to be visited at least once a month by the Credit Officer, while those with repayment delinquencies require more frequent visits."

(ShoreCap Exchange, Micro and SME Training, Manila Training, September 2005)

Delinquencies can also be caused by external factors, such as a natural disaster (flood, or fire), which affects many borrowers, or unforeseen circumstances (theft of property, illness, death), which affect one or more borrowers. In many of these cases, the client still has the willingness to repay, but not the means. The MFI would need to analyse the situation carefully and decide what to do for these clients.

In Bangladesh in 1999, there was a disastrous flood that effected many clients in the areas located around the rivers. One of the largest MFIs did not address the situation in a timely manner and ended up with a very high PAR, even 18 months after the flood and "supposedly" due to the flood. They wanted to restructure all the delinquent loans where the clients claimed to have been affected by the flood. During the analysis process, they overlaid a map of the flood-affected areas, with a map of the delinquent clients before the flood, and zero to six months after the flood. The results showed that over 40% of the newly delinquent clients after the flood did not live in flood-affected areas. As a result of the flood and not acting quickly to address the clients' needs, the MFI had an even larger problem on their hands - a loss of reputation and credit culture.

Q: How do you prevent delinquency and problem loans?

Although a MFI and/or Credit Officer cannot prevent clients who do not tell the truth or emergency problems in a family, a MFI and Credit Officer can be proactive and prevent (or at least foresee) potential delinquency by:

- Using good lending practices
- Conducting thorough due diligence
- Structuring the loan properly
- Monitoring closely
- Evaluating internal and external environment

For borrowers, delinquency can happen very easily. A birth, marriage, serious medical ailment, or death in the family can prevent a member from producing his/her income. Clients have little savings to buffer these events.

A household or small business has little "slack" in its personal, financial and physical resources and is often far less able to predict future problems. This means that the small business is very vulnerable to outside factors like a natural disaster or a change in the supply of inputs, because it has fewer resources to buffer the impact of those changes.

Serious changes can happen in a very short time. Time, or time lag, is your enemy. The sooner you catch delinquent borrowers, the less your portfolio will be hurt.

Q: What do you do when a loan becomes a problem?

The Credit Officer must first assess and then act. After a loan becomes a problem, sometimes even before delinquency, the MFI must make an assessment of the situation **prior** to deciding on a workout strategy. MFIs must determine whether this is a temporary problem or if there is an actual weakness in the company. In keeping with conservative underwriting principles, **it is better to plan for the worst than the best case scenario**. **Caution rather than alarm is the better view when first encountering a past due loan.** A deliberate gathering of information will lead the MFI to the true cause of delinquency or problem. Some causes can be avoided by the actions of the MFI and some cannot. Further, sometimes the borrower has retained the capacity to repay, but does not want to. These are the most difficult types of delinquent borrowers.
Make new collection policies, but keep the old – one is silver and the other gold…

MFIs and Credit Officers should still utilize ”old” (group) collection methods such as: (1) peer pressure, (2) talking with in-laws, community leaders and church leaders, and (3), embarrassment through public exposure.

The Credit Officer must keep open lines of communication with the borrower BEFORE the loan becomes delinquent. A work-out strategy should begin while the borrower has an opportunity to make adjustments to their business.

Q: What is loan work out?

Loan workout is an exercise or series of steps that a Credit Officer undertakes to find options for recovering the loan, such as:

1. Acting quickly in assessing the borrower. Prompt action can mean the actual recovery of a loan or not
2. Checking the credit file to make sure all documentation is in order
3. Developing a plan for business recovery and on time repayment
4. Checking the legal position and also physically see the collateral to make sure it still exists
5. Keeping deadlines

The client should understand that the MFI is serious and definitely plans to recover its funds. It is very important to set a precedent for all clients. Remember the South Asian MFI with the flood problem where even clients who were not in the flood-affected areas took advantage of the leniency of the MFI during this disaster and did not repay.

Workout Assessment Questions

1. What is the company's current situation?
2. What are the problems?
3. How are you working to solve the problems?
4. When can you make the past due payment and how can we avoid this occurring again?
5. How many items are currently produced? Daily, weekly
6. How many items are currently sold? Daily, weekly
7. What is the current selling price?
8. What is the current level of inventory, length of time?
9. What is the current cost of raw materials?
10. How many employees are working at the company? Are the employees receiving their salaries?
11. How much are the accounts receivable? How old is each item and what are the prospects for collecting? What steps are you taking to collect?
12. Do you have any taxes due or overdue? Will you be able to pay your taxes?
13. Do you have any other accounts payable? When are they due? Are they overdue?
14. Have you changed accountants?

Q: What is the best course of action?

Remember that while the main goal of the bank is to be repaid, it is not in the interests of the bank or the borrower to inflict unnecessary hardship on the business. As we have discussed, it is cashflow that is the primary source of loan repayment and the MFI has to decide whether the cooperative borrower continuing in business has a chance of servicing their debt. It is important that the sources of this cashflow/prospects for repayment be based on in-depth analysis because all borrowers are likely to seek more time.

How the Credit Officer reacts to the first signs of a problem will affect the bank's relationship with the borrower and perhaps other borrowers, as well. The instinct of many Credit Officers is to keep quiet about a potential problem in the hope that it will go away. This is the most dangerous response. The key is to act quickly to identify the nature of the problem and the strength of the bank's position. On the basis of this, an appropriate plan of action should be quickly established and implemented. The speed of the Credit Officer's response is often the most important factor in collection of the loan. In some cases, a fast and effective response sets the borrower on the path to cooperation by showing him that the MFI is serious about him fulfilling his obligations in a timely fashion. In others, the fast response minimizes the time available for an uncooperative borrower to cover his tracks by moving collateral or cash.

The best course of action will depend on the following:

- Cooperation of the borrower: A workout plan can only be effective with real cooperation of the borrower. The Credit Officer can best secure this cooperation by responding quickly and firmly to warning signs, but focusing on understanding the problem rather than threatening the client.

- How bad the situation is: The Credit Officer's plan should be appropriate to the seriousness of the problem. Over-reaction or unnecessary aggressiveness will result in loss of the customer's cooperation. The bank will then be left without information and with limited alternatives for obtaining repayment.

- The strengths and weaknesses of the bank's position: This depends upon the value and liquidity of the collateral, the adequacy of the documentation on the loan and the bank's legal position in terms of collection.

- What caused the problem: The potential courses of action are as numerous as the types of problems that can arise. Each case should be dealt with individually.

Q: How do you develop an action plan?

There are no precise steps. Each and every workout situation is completely unique. It is difficult to give exact action plans to the Credit Officer. Instead, the Credit Officer, together with the Manager and client, must work to come up with a suitable plan where the client can actually repay the loan. The Credit Officer must understand the client and be creative in their plan.

There are a few rules for developing the plan. The plan should be:

1. Realistic.
2. Mutually agreed upon by both the client and MFI.
3. In writing and signed by both the MFI representative and the client.
4. Followed and monitored by the MFI.

The client should receive one copy and another should be filed in the client's file. This will help to remind the client of his/her obligations and document the situation in case it ends up in court. As indicated in the restructuring section below, any extension of terms or grace period must be approved by the Credit Committee.

Remember: A legal settlement is the last resort, as it is very time consuming and extremely costly. If a viable repayment arrangement cannot be developed, then it will be necessary to liquidate assets. At this point, a "cooperative borrower" may well cease to cooperate. The client must be made to realise that a workout is always better than repossession of collateral – both for him/her and the MFI.

Arrears Committee at the Micro Enterprise Bank (MEB), Philippines

The Arrears Committee oversees and examines critical cases of arrears that have been written off. It also attempts to identify any deficiencies in the credit analysis and evaluates the legal measures, which have been initiated by the Credit Officers to recover delinquent loans.

MEB practices zero-tolerance on delinquent loans. All measures are taken to ensure that loans are current and up-to-date. When a loan falls into default, the Credit Officer exerts all efforts to solve the delinquency problem at an early stage; specifically, within the first week. If the delinquency falls into the over seven days PAR category, red flags are raised. At this point, the Credit Officer discusses the problem with the Credit Coordinator; they visit the client and guarantors together. Another option at this stage is to tap the compulsory savings deposit of the borrower.

If the client has not paid the arrears soon after, a collection letter is given to the client and the Branch Manager is called to assist in the collection efforts. Drastic measures such as notifying the Barangay Captain (Village Chief) or enforcing the security agreements may be used.

As a very last resort, legal action is taken to recover the collateral and payment. As of September 2005, MEB had only taken legal action against one borrower for non-payment.

(ShoreCap Exchange, Micro and SME Training, Manila Training, September 2005)

Q: What are the stages of workout?

There are four stages to workout:

Stage 1: Watch List
A problem loan is identified and placed on a "Watch List" and the loan grade is adjusted accordingly. Payments at this point may well be current, but the MFI has received some adverse information or there has been, for example, a change in the business or political environment that gives cause for concern. At this point, the MFI may require that the loan be taken to a "Problem Loan Committee". This committee is usually composed of the same members as Credit Committee. At this stage the Credit Officer would present the client's situation and suggested options for the action plan. Then the committee would discuss the options.

The loan will require very close monitoring and status reports will be included in a monthly Problem Asset Report, which is provided to the MFI management.

Stage 2: Workout Arrangements
Stage 2 is for loans that need "work out" arrangements, but full repayment is expected from cashflow, albeit payments may be delayed.

There may well be logical and acceptable explanations for this situation, for example:

- delayed collection of receivables that are still considered good
- late delivery of equipment financed by the loan

In such cases the underlying project should still be sound but the payment terms are too ambitious. Penalty interest might be applied and/or the loan may be refinanced, depending upon the circumstances of each particular case.

As with any past due loan, the Credit Officer must have a specific, approved plan of action for repayment.

Stage 3: Non-Accrual

(1) Repayments have slipped past 60 days and there are underlying problems with the loan that indicate that the business is no longer capable of repaying this loan within a reasonable period of time and/or repayment will probably depend upon the sale of collateral.

At this point the MFI should place the loan on a "**Non-Accrual**" basis. This decision is made by the Credit Committee or 'arrears' committee if there is one.

(2) The loan is on a non-accrual status and as such, specific action will usually be required on the part of the MFI in order to obtain repayment of the loan. Such action may include the repossession of collateral and/or foreclosure on real estate and/or enforcement of guarantees, etc. Speed of action is often of paramount importance.

Loan Accounting - Non Accrual

According to international accounting practices, a loan is placed on a non-accrual basis because it is now a work-out loan and can no longer be regarded as an interest-earning asset of the bank. Repayment of the principal is far from certain and therefore all payments received should be applied to principal. Only after the principal is repaid, can payments be applied to interest.

This policy may depend on the regulations of the National Bank.

Stage 4: Write-off

The loan is "Written-Off" after 90 days. The Credit Officer will continue to work towards recovery and provide written progress reports quarterly or at other times requested by management. Sometimes the Credit Officer is unaware that the loan has been written off.

Important Note: The Credit Officer, Collections Officer, or other designated MFI staff member should continue to follow up and apply pressure to delinquent clients, **even when the loan has been written off**. The client should never believe that the MFI has given up collecting.

Q: What is restructuring?

Restructuring is when the lending institution adjusts the original loan repayment schedule to compensate for extraordinary events faced by the client. This procedure is called restructuring due to the loan actually taking on a new form and shape (i.e. the loan will have different conditions from the original loan: term, interest rate, amount paid per month and/or collateral).

'Extending' a loan (giving a grace period and/or a longer period to repay) is restructuring and should not be done, except in rare cases.

Q: What is the risk of restructuring?

Restructured loans are more likely to become delinquent. Restructuring can be a seductive trap that helps keep portfolio measures looking good, and avoids tough borrower issues. They are often overused and misused, and whatever improvement may appear, it is short-term and counterproductive.

Q: What clients qualify for restructuring?

There are very few cases in which a client qualifies for restructuring. Some of the exceptions are:

- Severe damage to business or house as a consequence of a force majeure situation such as a natural catastrophe, war, riot or coup attempt
- After an extraordinary event give the borrower some time to demonstrate their willingness to repay
- For clients who have lost all their working capital

MFIs must account for restructured loans separately on their balance sheet. These are not part of the current (non-delinquent) outstanding loan portfolio. Additionally, restructured loans have a more stringent loan provisioning than current and delinquent loans. This is often regulated by the central bank's regulations. If the MFI is not regulated, then they should set a higher provision for these loans as they are more risky than current loans.

Q: Once the decision to restructure is made, how does it work?

Restructuring should follow the exact same procedures as a new loan would undergo. The Credit Officer must complete a Loan Appraisal form, cashflow and give a recommendation to Credit Committee. Then, Credit Committee makes the decision whether the client is eligible and approved. If not, the Credit Officer and Manager must come up with alternative options.

Other particularities of restructured loans:

- They should make up only a very small percentage of the total portfolio (at the absolute most <5%). In the case of a natural disaster or economic event that affects a

large portion of the population, the number of restructured loans in a portfolio may be greater than 5%.
- They reduce program income and increase portfolio risk. Loan loss reserves are usually higher for this category of loan.
- They encourage the borrower to move in the wrong direction because they suggest that there is a benefit to be gained by falling behind on payments.

Restructuring can sometimes be a necessary and/or useful tool. Healthy restructuring implies an improved collateral position for the loan fund (i.e. extra collateral should be secured at this time). There should be a clear rationale behind the restructuring and a belief that the loan will be repaid.

A general rule is to never restructure a problem loan.

Q: Is restructuring part of a regular workout procedure?

NO, it is the last resort to a devastating problem, not a solution to a workout situation. Loans that are under workout usually are problem loans that are controllable by the client and should not be considered for restructuring. Also, just because it is the last resort, it should not take a long time to make the decision to restructure. The quicker you are able to get the client back on track, the quicker the client is able to pay the MFI!

Restructuring can be a successful financial tool, but it only applies to a very few cases. The percentage of good quality restructured deals in a portfolio is usually low, namely not more than 5%.

Restructuring effectively, means granting a new loan (i.e., you trust the client to repay). The Credit Officer must go through the same due diligence as with a first time borrower. Clients may face additional problems if a loan is not restructured properly. Improper restructuring will only delay the problem. If the MFI has any doubts about the borrower or the borrower's future business, the loan should not be restructured.

Q: What kind of MIS problems can be caused by restructuring?

Many MFIs' information systems cannot handle restructured loans. In most of these cases, the MFIs must actually manipulate the system by manually repaying the outstanding loan and booking a new loan. If this is the case, they must keep a manual tally of the restructured client, loans, outstanding balance, and other details. This must be manually added to their financial statements and records. Ultimately, there will be mistakes and miscalculations.

The MFI should advise the participants that this situation with the MIS supplier before purchasing a new MIS.

Q: If that is restructuring, then what is refinancing and when is it used?

Refinancing is replacing one loan with another, usually larger, loan.

MFIs could use refinancing when the business has grown far beyond the cashflow and its growth will be stunted if it doesn't refinance the existing loan with a larger loan. The MFI would issue a second loan, which is larger than the outstanding balance of the first loan. The second loan would be used to pay down the balance of the first loan and then for additional projects. Refinancing can also be used when a MFI is taking over a client from another institution to refinance the original loan at the same outstanding amount.

WATCH OUT: Refinancing is also used in workout situations by institutions or clients themselves. When there is a problem loan, another MFI may try to get the client to take out another loan or the clients themselves may initiate this process to repay the problem loan. It is extremely important that you check clients thoroughly and that this is not happening. A Credit Bureau would be a very good solution to aid in this predicament. If there is not a credit bureau and you know that other MFIs are operating in your region, at least Credit Officers and MFIs should exchange "black lists" or call other MFIs before disbursing loans.

Both refinanced and restructured loans, as a result of a workout solution, are high risk loans. The loan loss provision should be more stringent than for current loans and both types of loans should be monitored more carefully.

To be Restructured:

- The local currency devalued over several months and the bakery had difficulty buying flour at the 30% increased price for a period of 3 months. This caused decreased sales and a drop in customers. Eventually the client could not make the monthly repayments, but paid some.
- A client has lost a majority of sales due to the re-routing of the major highway where he used to sell goods at the cross roads.
- Winds blew the roof off a client's business during a storm and she lost 30% of the goods due to water damage. She had to repair the roof, costing her $1000.
- The government changed the laws and the business had to pay a one-time tax of $800 which caused non-payment for two months.
- Production facilities had to be upgraded due to a new health certification law.
- An earthquake hit the region and the borrower lost his house and all the inventory of the business.

NOT to be Restructured:

- The tax authorities came to claim all back taxes, which the client had not paid.
- A client invested into another business, which is causing the delinquency.
- A client built an extra room onto the restaurant that was not in the project, but he said he needed it.
- A client has a repayment problem, due to expenditures for her daughter's wedding.
- A client loses customers due to her lack of flexibility to adjust to the changing market demand for higher quality goods.

Red Flags:

Monitoring is one of the most important steps in the loan process! Credit Officers tend to get caught up in other work first, and leave monitoring for last – or never!

Any changes in the business, both positive and negative, are the Credit Officer's clue to potential problems.

Poor collection culture and product design can lead to high institutional PAR.

The number one cause of delinquency and non-payment is giving a client a loan that is too large.

Be aware of clients coming from another MFI, as they may be trying to refinance a bad loan.

Restructuring should be done rarely, thought through very carefully, performed as a solution for a client with a problem related to a current loan; not a delinquent loan and only done if you the client can meet the new obligations and if you secure extra collateral.

Restructured loans are high risk and need to be closely monitored.

If the MFI's MIS cannot handle restructured loans, these need to be separately and manually tallied, tracked and provisioned for at a more stringent rate than current loans.

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