

Lending Methodology Module

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1. What This Module Covers

This module will provide an outline of the diverse program structures and operational methodologies employed by microlending institutions today. There are several distinct models of popular microlending methodology. Among them, the Grameen Bank model may be the most well known. This module will introduce the reader to other models of microlending that have been formulated and applied in different parts of the world and will outline the most important differences between models.

2. History of Microlending Methodology

The practice of microlending is not new. Credit cooperatives and charities making loans to young entrepreneurs have been documented from 18th century Europe.¹ A notable example is the fund created by 18th century novelist Jonathan Swift. Swift donated £500 of his own wealth for lending to “poor industrius tradesmen in small sums of five, and ten pounds, to be repaid weekly, at two or four shillings, without interest.”² Another interesting historical example of microlending is the Irish Reproductive Loan Fund Institution, which came into existence following the famine in 1822. This fund, which received donations from charities in London, was established to make small loans (under £10) to individuals in small towns for “relief of the distressed Irish.”³

German credit cooperatives in the late nineteenth century provide an example of historic group microlending. These cooperatives were often located in rural areas where individuals knew each other well. The cooperatives provided credit services, and importantly, many had

¹ Hollis, Aidan and Sweetman, Arthur, “Microcredit: What Can We Learn From the Past?” *World Development* 26(10):1875-1891, October 1998.

² Sheridan, T., 1787. *The Life of the Rev. Dr. Jonathan Swift*, 2nd Edition. P. 234

³ Hollis, Aidan and Arthur Sweetman, “The Life-cycle of a Microfinance Institution: the Irish Loan Funds,” *Journal of Economic Behavior and Organization* (46(3): 2910311.

a policy of unlimited liability. That is, if the cooperative failed, any member could be sued for the entire amount owed by the cooperative. Interestingly, these credit cooperatives were the inspiration for the credit union movement in the United States.⁴

Microcredit became an important tool in the world of development finance starting in the 1970s. Over the past three decades, older microlending methodologies have been tested and new methodologies developed. Operations in diverse economic, political, social, and legal environments have inspired new creativity in microlending methodology. It has become clear to practitioners that there is not one correct microlending model, or even one correct model in a given operating environment.

3. Current Popular Microlending Methodology

A specific microlending methodology is chosen to fit the needs of the target client group, conditions in the local environment (economic, social, political, and legal), and goals of the program. As a result, there are no two completely identical approaches to microlending. However, nearly all microlending programs can be classified as belonging to one of a limited number of microlending models. The purpose of this section is to introduce the reader to the methodological variation that exists in the field.

All microlending programs can be divided into two general categories: individual lending programs and group (or peer) lending programs.

3.1 Individual Lending Programs

Loans are given to individual borrowers. The bank performs a thorough analysis of every potentially funded business venture. Borrowers receive loans based on past performance, credit histories, viability of business propositions, and references. To encourage repayment, borrowers provide collateral and co-signers. Credit officers form close long-term relationships with clients.

The individual approach is most commonly associated with commercial banks. Successful individual microlending programs are usually highly modified variants of

⁴ Prescott S., 1997. "Group Lending and Financial Intermediation: An Example," *Economic Quarterly*, volume 83/4 (Fall), pp. 23-48.

systems employed by commercial banks. Individual lending has been applied most successfully to urban clientele.

3.2 Group (or Peer) Lending Programs

Just as individual lending programs disburse loans to individuals, group lending programs disburse loans via groups. In this case, group members guarantee the repayment of each other's loans. Collateral and co-signers are generally not used, peer pressure and collective responsibilities generated by the group take their place. In addition, functions typically performed by the bank staff are delegated to the borrower group: peers screen clients, determining who to accept into their group; loan analysis by the lending institution is minimal, depending instead on peer assessments of each other's businesses.⁵

3.3 Operational Structure of Group and Individual Methodologies

Individual and group methodologies require different structures of operational and financial organization. It is important for the most appropriate structure to be selected based on organizational goals, profitability objectives, and risk tolerance.

Individual lending and group lending have different cost structures. Individual lending requires careful analysis on behalf of the lending institution prior to fund disbursement. Evaluating the loan proposal and defining the terms for each particular client, which may take several weeks, is costly to the lending body. In contrast, group lending is less time consuming, and hence less costly, *prior to fund disbursement*. However, managing groups requires additional and greater costs *after* closing.

Operational costs for group lending tend to be higher than those of individual lending, largely due to the additional time required for managing groups. In addition, because the bank holds no collateral, group lending is considered riskier than individual lending. High operational costs to the bank combined with relatively high risk require high revenues if the lending institution is to be sustainable. As a result, group loans are usually more expensive and have higher rates of interest than individual loans.

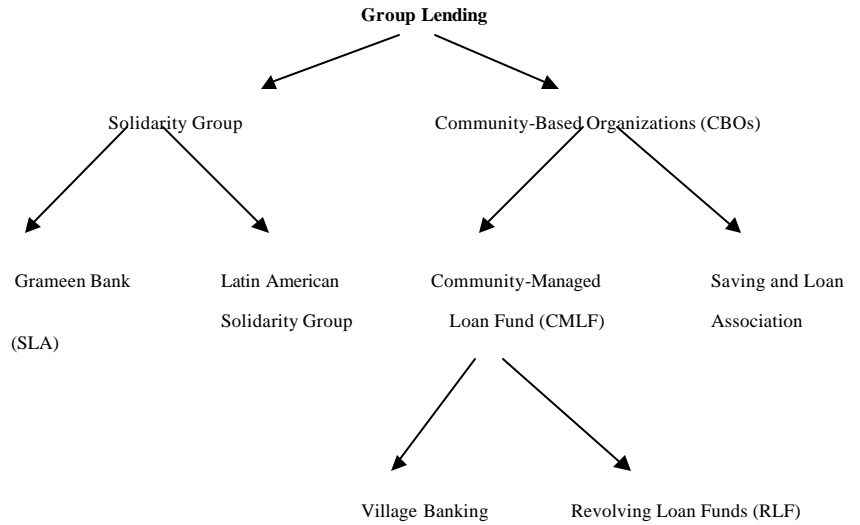
In summary, interest rates on group loans tend to be higher than interest rates on individual loans. Group lending has lower closing costs but higher maintenance costs and higher

overall costs than individual lending. It is important for a microlending organization to evaluate these tradeoffs when deciding on a methodology.

4. Approaches to Group Lending

Unlike individual lending programs, which tend to generally follow the same approach, there is wide methodological variation among group lending programs (as shown in Scheme 2.1).

SCHEME 2.1.⁶



Below is a discussion of group model characteristics, as of 1996. The structure and substance of this material comes largely from the *CARE Savings and Credit Sourcebook*.

4.1 Solidarity Group vs. Community-Based Organization Approaches

Group lending programs can be subdivided into **Solidarity Group** approaches and **Community-Based Organization (CBO)** approaches. The distinction between the

⁵ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

⁶ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

Solidarity Group approach and CBO approach to group lending has to do with the desired future relationship between the lending body and the borrower group. CBO approaches have as a primary goal the eventual independence of the borrower group from the lending body. To this end, the lending body encourages the development of the internal financial management capacity of the group, so that the group can act as its own mini-bank. Solidarity Groups are those programs that do not anticipate the eventual graduation of the borrower group from the lending institution. Participants are considered long-term “clients” of the program.⁷

4.2 Solidarity Group Models

4.2.1 Grameen Bank Model

One of the most famous examples of the solidarity group model is the Grameen Bank. The Grameen Bank, founded by Muhammad Yunus in Bangladesh in 1976, was the first microlending program to use a solidarity group approach. The bank has grown very rapidly. In 1992, it lent to 2 million people at real interest rates of around 12 to 16 percent. Their repayment rate is high, around 97 to 98 percent. The bank even shows a profit, though it would not do so without the low-interest loans and grants it has received.⁸ The following is a summary of Grameen methodology:

First, staff identify a potential village and conduct a one or two week training course in the village to orient future clients to the philosophy, rules and procedures of the program. Then, groups of five unrelated, self-selected prospective borrowers are formed. Between six and eight of these five member groups are come together to form a village “center”, groups of which in turn form Regional Branch Offices. Branch workers work with a large number of clients (usually 200-300) and do not evaluate individual loans. Instead, branch workers leave clients or members to assume responsibility for much of the management of financial services. In the Grameen model, groups of borrowers do more

⁷ Waterfield, Charles and Duval, Ann, “CARE Savings and Credit Sourcebook”, CARE, 1996. Chapter 6.

⁸ Morduch, Jonathan. “The Microfinance Revolution,” Harvard University Department of Economics (draft), 1997.

than just guarantee loan repayment—they become a part of the institutional structure of the bank. Hence, the institution is built “from the ground up.”⁹

New groups of potential borrowers meet and save for a minimum of 4 weeks before any loans are granted. The group appoints a group leader (whose position rotates among all group members) and group members determine the rotation of access to credit. Two members of the group receive the first loans, which are generally under \$100. After timely repayment for four to six weeks, two additional members receive loans. After another month, the fifth member (usually the group leader) receives his or her loan. The responsibility for loan repayment is the legal obligation of all five group members, regardless of which group member received the loan. If any group member defaults on a loan, the other four members must cover the loan. None of the members will receive further loans until the delinquent loan is repaid. In this sense, a sense of collective responsibility serves as collateral on the loan. When groups have established a good repayment history, loan amounts are gradually increased, but normally do not exceed \$300.

In addition to repayment requirements, the Grameen Bank incorporated strong social requirements into its program. Known as the “Sixteen Decisions” these requirements state that borrowers must educate their children; maintain their own health and the health of their families (by boiling all drinking water, maintaining a clean environment, using pit-latrines, and exercising); commit to growing vegetables all year round; not participate in the dowry system. For the full text of the Sixteen Decisions, see Appendix A.

The Grameen model provides credit to the very poor in rural areas without requiring any collateral. To this clientele, who historically have very little access to credit and almost no access to credit at low interest rates, microloans have proven an effective weapon in the fight against poverty. The Grameen Bank has received worldwide attention for this model. More than 4,000 people from some 100 countries have gone through Grameen's training and exposure programs over the last decade. Many of those visitors have returned to their countries and replicated the Grameen Bank model— a total of 223 Grameen replication programs in 58 countries. Through funding sources such as the International Fund for Agricultural Development and the United Nations Children's Fund

⁹ Waterfield, Charles and Duval, Ann, “CARE Savings and Credit Sourcebook”, CARE, 1996. Chapter 6.

among others, the Grameen model of microfinance has been able to reach several hundred thousand poor borrowers around the world.

The Grameen model works best in densely populated rural areas with a static population. Clients are usually women, and loans are usually used for agriculture and retail.

4.2.2 Latin American Solidarity Group Model

In the early 1980's, loan programs in Latin America using individual methodologies considered the success of the Grameen experience and looked for ways in which certain aspects of the Grameen model could be incorporated into their existing programs. The result was the Latin American Solidarity Group model. There are two main differences between the Latin American model and the Grameen model.

First, the Latin American solidarity group model chose to retain loan approval and administration, using the already-existing operational systems developed for individual lending. For example, credit officers perform an analysis of each client's loan request (though this analysis is significantly less extensive than in the case of an individual loan) and visit all group members at their place of business prior to fund disbursement. Group formation is simply a loan guarantee mechanism—groups do not become a part of the institutional structure of the bank.

A second difference is that Latin American solidarity groups are much more focused on the provision of credit than the more socially-oriented aspects of the Grameen model. The Latin American methodology is a minimalist approach, that is, institutions that follow this model often offer only credit services.¹⁰

An interesting example of solidarity group model is BancoSol, located in Bolivia. It is a chartered bank, subject to the supervision of SIB, the Bolivian bank regulatory agency. It makes uncollateralized loans for periods of 12 to 24 weeks with frequent repayment terms (one or two weeks). Loans are made to solidarity groups of four to ten members and are apportioned among group members. Loans from BancoSol are usually made to provide working capital for small-scale business activities. Most borrowers are market vendors,

though half of the portfolio is lent to small-scale producers like shoemakers, bakers, and tailors.¹¹

Like the Grameen bank, BancoSol has experienced rapid growth. In 1996, BancoSol lent to about 75,000 people, roughly one-third of the people who use the Bolivian banking sector. In 1996, BancoSol had a loan portfolio of \$47.5 million. It also earned \$1.1 million on revenues of \$13 million.¹² The BancoSol model and the Grameen model have two main similar features. Firstly, group members are jointly liable for each other's debts. Secondly, the majority (77 percent for BancoSol) of clients are women. Unlike the Grameen Bank, most of the borrowers of BancoSol are located in urban areas.

4.3 Community-Based Organization (CBO) Approaches

Models of group lending which have as a primary goal the development of the internal financial management capacity of the group are characterized as CBO models. In contrast to Solidarity Group approach, which does not anticipate the eventual graduation of borrower groups from the lending institution, CBO approaches aim to develop a mini-bank, independent of the lending institution, owned and managed entirely by the poor. Microlending models using the CBO approach can be divided into two subgroups: Community-Managed Loan Funds (CMLF) or Saving and Loan Associations (SLA). The distinction between CMLFs and SLAs is

- CMLFs receive initial funding from outside the organization (in the form of a loan or grant). There are two main approaches to community-managed loan funds—Village Banking and Revolving Loan Funds.
- SLAs generate all funds internally (through member savings or retained interest) and receive no external funding

4.3.1 Community Managed Loan Funds (CMLFs)

¹⁰ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

¹¹ Glosser, Amy J. "The Creation of BancoSol in Bolivia," in Maria Otero and Elisabeth Rhyne, eds., *The New World of Microenterprise Finance*. West Hartford, Conn.: Kumarian Press, 1994.

¹² Friedland, Jonathan. "Bolivian Bank Thrives with Little Loans," *Wall Street Journal*, July 15, 1997.

4.3.1.1 Village Banking

Village Banking is probably the most practiced kind of Community-Managed Loan Fund.¹³ The Village Banking methodology was developed by the Foundation for International Community Assistance (FINCA), a U.S. based nonprofit organization that specializes in rural credit. Programs using this methodology have been widely replicated in different parts of the world by other NGOs. This approach has been successful at reaching poor segments of the population in rural areas.

A Village Bank is initially financed through loans provided by a lending institution. Over time, member savings, share capital and accumulated interest are expected to grow large enough so that no external funding will be necessary. In general, the objective is for each Village Bank to be administratively and financially autonomous by the end of three years, at maximum. Savings mobilization is an integral component of the Village Banking methodology. Savings is more central to the Village Bank model than to either the Grameen Bank model or the Latin American Solidarity Group model. Village Bank members are required to save prior to receiving a loan and to continue saving during the loan cycle.¹⁴

Implementation of a Village Bank program generally follows the following course:

1. Staff from the NGO or lending institution research and visit potential zones for Bank development. Once a zone is considered eligible, staff present the methodology to local leaders and interested members of the community. If individuals decide to form a lending group, staff train the group in Village Bank practices and work with the self-selected and self-screened group to form and train a management committee. A Village Bank usually has between 20 and 50 members, often women.
2. Individual bank members negotiate their initial loan amount (usually under \$50) and terms with the group, and each request is approved by the other members of the group. Program staff do not conduct loan analysis. The Village Bank receives an initial loan equal to the aggregate amount requested by individual borrowers.

¹³ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

¹⁴ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

3. Funds lent by the lending institution or NGO are placed into the Village Bank's "External Account" and the Village Bank loans these funds to members. The Village Bank must repay the lending institution the original funds with interest in a specified period of time. Bank members are jointly responsible for repayment—if any member fails to repay her personal loan, the other members must make up the deficit. Members are not required to provide collateral or cosigners; instead, the program relies on social pressure to guarantee loan repayment.

The Village Bank manages two accounts. The "External Account", comprised solely of funds lent to the Village Bank by the lending institution, and the "Internal Account". The internal account consists of funds belonging to the Village Bank. The two primary ways the Village Bank accumulates funds in its internal account are:

- a) Through regular member savings deposits;
- b) If the Village Bank loans funds to members at an interest rate greater than that charged by the NGO or lending institution, interest payments made by members in excess of interest owed to the NGO flow into the internal account

Village Bank members determine the rules for borrowing or using funds from the internal account. Typically, funds that accumulate in the internal account are used to make additional loans to members, or to make up some deficit, should a member default on a loan. Village banks may choose to make higher-interest loans to non-members from the internal account.

The primary goal of the Village Banking model is for the resources in the internal account to grow over time, and displace the need to borrow from a lending institution or NGO. As the Village Bank becomes independent of the lending institution, bank policies become determined democratically by its own members and the bank becomes autonomous and self-sufficient. A noted criticism of the Village Bank model is that Village Banks may not be able to meet this goal because credit demand tends to grow faster than the Village Banks' ability to mobilize savings.¹⁵

¹⁵ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

4.3.1.2 Community-Managed Revolving Loan Funds (RLF)

The Community-Managed Revolving Loan Fund model is similar to the Village Bank model in important ways. Both models use initial outside funding to work towards the goal of establishing an independent and sustainable bank, run and managed by the local community. Outside funding is channeled directly to the RLF, which then makes loans to individual members. A RLF group typically consists of between 30 and 100 members, often women. Like the Village Bank model, the RLF model requires members to save prior to the initial loan.

There are key differences between the RLF model and the Village Bank model. They include the following:

1. Initial funding can be in the form a grant from an NGO or in the form of a loan. The amount of initial funds provided to a RLF is usually a multiple of the equity, or initial savings, of the group, often no more than \$50 per member. When initial funds are provided as a loan, the repayment period is usually long (at least 2 years).¹⁶ After the initial grant or loan, additional funding is usually not provided.
2. Individual loan repayment terms, which are set by the group, may vary greatly within the group depending on the purpose of the loan (short-term working capital loans vs. long-term capital investment or agriculture loans).¹⁷
3. Member savings, though required for all members in the initial period, may not be required after the initial period.
4. Peer pressure is the primary means to guarantee repayment, but RLF groups may chose to require some form of collateral.

4.3.2 Savings and Loan Associations

A Savings and Loan Association (SLA) is very similar to a community managed loan fund with one important distinction: funding for SLAs comes from member savings and

¹⁶ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

¹⁷ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

equity contributions only, and no outside funding is accepted. Savings and Loan Associations are always entirely financially independent of outside institutions, even in the startup period. Development institutions and NGOs may contribute technical assistance and training in the startup period, but loans are always financed entirely by the member base.

Groups usually consist of between 30 and 100 members. Savings mobilization is an essential feature of this model. Each SLA determines its own rules regarding required member savings amounts. Often, some savings deposit is required of every member at each meeting. Each SLA also determines its own terms and conditions for individual loans. Loan amounts may be determined by the amount an individual has saved with the group, or loan amounts may be uniform across group members. Loan repayment terms can vary greatly within the group, depending on the purpose of the loan (short-term working capital vs. long-term agricultural). Interest rates are often set at an extremely high level as a means to rapidly capitalize group funds.¹⁸

For further information on specific lending methodologies, see C. Waterfield and A. Duval's CARE Savings and Credit Sourcebook (1996), Chapter 6, from which this module borrowed structure and content.

¹⁸ Waterfield, Charles and Duval, Ann, "CARE Savings and Credit Sourcebook", CARE, 1996. Chapter 6.

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