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# Practitioner's Guide:

## Establishment of a Credit Programme

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Bundesministerium für
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und Entwicklung



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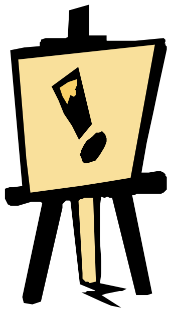
# Establishment of a Credit Programme

## Brief Description



International experience has proved that entrepreneurship promotion and small business development is an effective approach for creating new jobs, reducing unemployment, and generating income. Small enterprises are an important and integral sector in the market economies of developed countries as well as transition countries.

In countries in transition, many micro-entrepreneurs lack access to working capital. Without adequate working capital, entrepreneurs' abilities to expand their businesses, create an inventory, and overcome short-term cash flow problems are severely restricted. Field studies have shown that most entrepreneurs believe that money alone will solve all their problems. They are often unaware of other important success factors (see Figure 1). Few entrepreneurs trust commercial banks and most are reluctant to seek bank assistance. Even if bank lending was readily available and in demand, most new small businesses cannot post the collateral necessary to obtain a loan. Although credit is often available from moneylenders, the interest rates are prohibitive, ranging from ten to twenty percent per month.

Entrepreneurs with access to Micro Finance (MF) programmes can access an array of services which are required by the MF as part of the loan packages,

In rural areas a significant portion of the population in transition countries derive their livelihoods from rural income-generating activities: these may include animal husbandry, market gardening, and crop production, etc. Newly privatized land is often underutilized as farmer's lack the resources to procure the necessary inputs. For most of the rural population, it is difficult to obtain financing to expand rural businesses. The expansion of rural production is also limited by the lack of market outlets for produce. Processing facilities for primary products to add-value are few and far between.

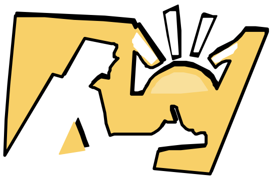
Under such circumstances, the implementation of a tailor-made credit programme as an (integral) part of regional economic and rural development projects can be particularly beneficial as it disburses capital directly to needy target groups.

# Establishment of a Credit Programme

## Proposed Main Users

- Public sector: ministries, regional and local governments
- International donor organizations active in regional economic development
- Local non-governmental economic development organizations

## Purpose of the Method



Central objective of the Credit Programme is to establish an efficient, interconnected financial system in conjunction with appropriate financial institutions who in turn provide a broad section of the population (in particular the poor) with access to local, cost-efficient, lending facilities. Furthermore, the Credit Programme also:

- Provides a broad sections of the population (especially the poor) with access to sustainable lending facilities. Those who benefit include: the poor in the informal and formal sectors such as micro-entrepreneurs (with sepcial focus on female entrepreneurs); Landless farmers; Entrepreneurs with small and medium sized businesses.
- Assist poor families' access financial services, leading to enhanced employment, income opportunities and eventually increased household incomes.
- Helps to build a sustainable, self-financing, locally-managed micro-finance institution capable of providing continued financial services to poor entrepreneurs.
- Enables intermediaries (e.g. financial institutions) to provide efficient and sustainable financial services.

**Figure 1: Entrepreneurs' awareness of success factors**

# Establishment of a Credit Programme

## Advantages

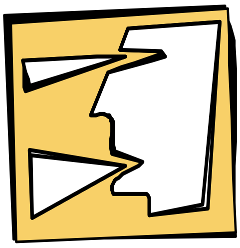
- Poorer sections of the population become bankable, i.e. are able to save and bear the full costs of commercial financial services;
- Enables the expansion of existing businesses;
- Increase of business activities, production, and trade volume;
- Refinancing of businesses short of working capital;
- Support for purchasing new equipment;
- Provides a good motivation for women to enter into business;
- Indirectly increases employment opportunities and creation of new job opportunities;
- Increases income opportunities;
- Contributes towards improving the livelihoods of poor families: increases finances means they can afford investments such as children's education and medical treatments;
- Eventually leads to an increase of tax payments due to higher income and increase of production and trade volume.

## Limitations

- Credit Programmes are confined to lending and are not sufficient to meet the demand for comprehensive financial services (e.g. deposit services, payment transactions, insurance).
- Limited repayment capacity of the target group due to poor management capabilities, production methods, technological standards and marketing opportunities.
- Appropriate deposit services are limited due to the banking laws in many transition countries. Financial institutions entitled to take savings require a banking license.
- Limitations as a result of the overall financial sector environment, e.g. banking laws, currency fluctuations, prevailing interest rates, and the presence of refinancing facilities, significantly influences the success of the Credit Programme.
- As an independent measure, it is doubtful whether Credit Programmes can make an effective contribution to improving livelihoods, many additional measures are needed at the same time.

# Establishment of a Credit Programme

## Principles & General Procedures



## Introduction

The successful establishment of a Credit Programme is dependent upon a number of key variables, including:

- Adequate infrastructure, skilled entrepreneurs, access to information, and a credit culture conducive to micro enterprises;
- Qualified management of the intermediary (credit organization) and well-trained human resources;
- Sufficient number of clients / beneficiaries;
- Urban or rural setting or combination of both;
- Proper credit products and conditions appropriate for the preferences of the target group (micro / small enterprises, agricultural enterprises);
- Efficient and streamlined operations to keep costs low;
- Motivated clients to repay the loans;
- Market-oriented interest rates and fees;
- Strategic planning for viability and sustainability;
- Efficient risk management;
- Cooperation with other agencies to provide add-on services;
- Government agreements or legislation conducive to MF organizations
- Financial oversight by central banks

The following ten-step procedure describes the most important elements that need to be addressed when developing a credit programme.

## Step 1: Preliminary appraisal

The preliminary appraisal should analyse the economic conditions in the market areas, market chains, local business cycles and rural seasonal activities, and assess the overall need/demand for (micro-) finance services. The appraisal must address the following questions:

- What financial services exist in the region? What types of credit are currently available or have been in the past?
- What economic activities serve as the basis for the local economy (e.g. non-agricultural activities, agricultural activities?)
- Is the borrowing and savings capacity of the target groups sufficient? What is the local repayment capacity?
- What is the potential volume of borrowing related to the target groups?

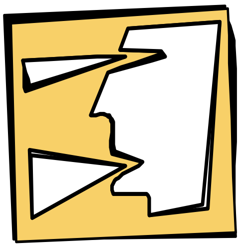
## Step 2: Identification of potential intermediaries

Suitable professional intermediaries must be identified and selected to implement and manage donor-supported credit programmes. Possible intermediaries to implement credit programmes are:

- Commercial banks;
- Micro-finance institutes;
- Financially-oriented NGOs;
- Savings and credit cooperatives;
- Financial self-help groups.

# Establishment of a Credit Programme

Principles & General Procedures



## Step 3: Pre-selection of potential intermediaries

Determine whether the credit policies and financial technologies of potential intermediaries correspond to the target groups' needs and clarify the interest of potential intermediaries in credit programme implementation.

Intermediaries must be capable of providing sustainable services to expanding number of borrowers. Therefore, they should have the following qualifications:

- Competence and experience in basic lending operations;
- Commitment to serving poorer clients, both women and men;
- Orientated toward outreach and sustainability;
- Concentration on client needs and close geographic and social proximity to borrowers;
- Legal and managerial autonomy (free from political influence);
- Effective and efficient management;
- Competent and motivated personnel with low staff fluctuation;
- Performance based salary structures for staff and management;
- Willingness to adapt new financial technologies and products;
- Cost-conscious organizational and operational structures;
- Well-functioning management information system and effective accounting system;
- Financial and annual reports in keeping with international standards;
- Regular external audits with an annual attestation by independent auditors.

The credit product available to the target groups is designed by the intermediaries. The range of the intermediaries' available credit products, and their orientation toward the target groups is one of the selection criteria. The available credit products are an important part of the proposal.

## Step 4: Organisation of a closed tender

Prepare a Request for Proposal (RFP) and invite pre-selected intermediaries to participate in the tender.

The RFP includes background information, statement of purpose, objectives, request for proposal with contact data and the applications guidelines. An application guideline which includes the elements to be covered in the proposal, is depicted in table 1.

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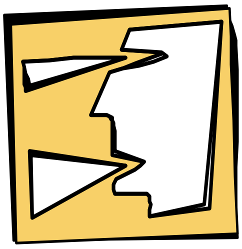

**Table 1: Application Guidelines for Intermediaries (Credit Organizations)**

| Main sections | Contents |
|---|---|
| ▶ Executive Summary | |
| ▶ Strategy and Implementation Plan | ▶ Objectives<br>▶ Target Groups (depth of outreach)<br>▶ Expected Results (scale of outreach)<br>▶ Assumptions, Risks<br>▶ Monitoring: Applicants are requested to identify performance targets that clearly describe the changes to the target group that will result from the project.<br>▶ Sustainability Plan: The project should have a clear and realistic sustainability strategy. Applicants should describe methods to ensure sustainability of the credit programme or outcomes. |
| ▶ Credit Policy and Guidelines | ▶ Loan Products, Conditions and Security<br>▶ Loan Application, Approval Procedure and Disbursements<br>▶ Monitoring and Loan Collection<br>▶ Reporting Procedures<br>▶ Accounting Methods |
| ▶ Project Management and Staff: Description of key personnel that will be directly involved in the implementation of the project in the field and headquarters. Provision of a short summary of relevant experience in the sector and the region. | |
| ▶ Financial Applications | ▶ Detailed Budget: Provision of detailed budget tables as an attachment. The budget should be broken down by year (monthly for the first year).<br>▶ Management Fee: The management fee covers all administrative, managerial support costs, audit expenses and non-project specific operation costs.<br>▶ Cost Sharing (or matched funds): If the management or programme costs are sourced from other than this funding, provide cost allocation methods among the funding sources, percentage and their justification. |
| ▶ Organizational Experience and Performance: Description of the role and experience of the applying organization in implementing similar projects. In particular, state specifically where the organization has a comparative advantage to implement credit programmes. Performance information over the past five years should be provided. | |

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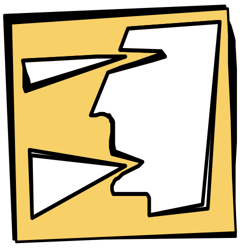

## Step 5: Selection of the most appropriate proposal

The final selection of the intermediary is made after a thorough assessment of the submitted proposals according to defined criteria.

Examples of criteria and their assigned weight in assessing proposals are shown in table 2.

**Table 2: Example criteria for assessing credit proposals**

| Concept-oriented (40 points) | Classification | | |
|---|---|---|---|
| **Strategy and implementation plan** | 1 to 3 | 4 to 7 | 8 to 10 |
| Average loan size (depth of outreach) | > 20 % higher than annual per capita income | Up to 20 % higher than annual per capita income | Below annual per capita income |
| Percentage of women (depth of outreach) | < 1/3 of loans disbursed | Within 1/3 and 2/3 of loans disbursed | >2/3 of loans disbursed |
| Number of borrowers (scale of outreach) | < 1.500 | 1.500 – 1.800 | > 1.800 |
| Impact monitoring | Indicators have to be defined | System partly available | System available |
| Sustainability plan | > 18 months | < 18 months | < 15 months |

| | Classification | | |
|---|---|---|---|
| **Credit policy and guidelines** | 1 to 3 | 4 to 7 | 8 to 10 |
| Range of loan products | < 2 | 2 or 3 | 4 or > 4 |
| Management information system | Manual MIS | Electronic MIS | Integrated electronic MIS |
| Reporting procedures | unfavourable | medium | favourable |
| Accounting methods | Local | | In accordance with GAAP |

| Organisation-oriented (40 points) | Classification | | |
|---|---|---|---|
| **Organisation / Management** | 1 to 3 | 4 to 7 | 8 to 10 |
| Management experience in MF | partly | Key personnel | All |
| Country experience | < 3 years | 3 – 5 years | > 5 years |
| Non-banking license | Intended | Registration in process | Registered |
| Staff experience in proposed loan technologies | low | medium | High |

Principles & General Procedures

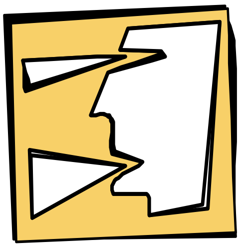

**Table 2: continued....(example criteria for assessing credit proposals)**

| Performance | Classification 1 to 3 | 4 to 7 | 8 to 10 |
|---|---|---|---|
| Number of borrowers (cumulated) | < 1,000 | 1,000 – 2,000 | > 2,000 |
| Percentage of women | < 10% | 10% - 20% | > 20% |
| Loans disbursed (cumulated) | < 1/3 of loans disbursed | Within 1/3 and 2/3 of loans disbursed | > 2/3 of loans disbursed |
| Portfolio at risk | > 10% | Within 5% and 10% | < 5% |
| Loan loss ration | > 4% | Within 1% and 4% | < 1% |
| Staff productivity | < 100 clients / credit officer | 100 – 120 clients / credit officer | > 120 clients / credit officer |
| Operation self-sufficiency | > 7 years | Within 3 - 7 years | Within 3 years |
| Financial self-sufficiency | > 10 years | Within 5 – 10 years | Within 5 years |

| Cost oriented (20 points)<br>Financial applications | Classification 1 to 3 | 4 to 7 | 8 to 10 |
|---|---|---|---|
| Direct expenses | High | Medium | Low |
| Management fee | > 12% | Within 12% and 8% | < 8% |
| Loan capital | < 1/3 of requested fund | Within1/2 and 2/3 of requested fund | > 2/3 of requested fund |
| Cost sharing | < 10% of total costs | Within 10% and 20% of total costs | > 20% of total costs |

## Step 6: Negotiation of financing agreement

The transfer of a credit fund to the selected intermediary should be regulated by a financial agreement. Based on the proposal and final negotiations, the agreement should specify the amount and purpose of the financial contribution, disbursement procedures, termination and duties of the intermediary, the specific target groups, the financial technologies utilized, and the required performance standards.

To ensure that the credit fund is managed efficiently, grants for institution-building measures and operational costs may be needed and are part of the financial agreement. Grants to help cover operational costs may be prudent at the start-up or expansion phase of a financial institution, but they must be subject to a clearly-defined time limit and gradually eliminated as business volume expands.

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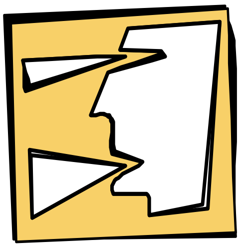


## Step 7: Supervision and monitoring

Effective supervision and monitoring of credit programme management should be based on the performance standards outlined in table 3. The intermediary should be obliged to submit regular reports. When performance standards are not met, the causes should be immediately determined and suitable remedial action undertaken .

## Step 8: Start of credit programme

The intermediary mobilises potential clients, informs the target groups about credit products and conditions, and initiates lending procedures according to the intermediary's operational manual.

The range of credit products and conditions should respond to demand from clients operating different types of businesses with different capital requirements, such as:

- **Credit Group Loans:** designed for new clients with modest levels of business activity and cash flow;
- **Progressive Group Loans:** in response to clients with larger capital needs, especially working capital needs;
- **Small Enterprise Loans:** in response to improved market conditions and un-met demand. The Small Enterprise Loan should serve clients who may succeed in expanding their businesses beyond the services available through group lending products, but who may not yet be ready to approach commercial banks for credit;
- **Rural Loan Products:** supporting the delivery of financial services to rural communities engaged in crop planting, animal husbandry, market gardening, dairy production, other processing activities, and trade in rural produce.

## Principles & General Procedures

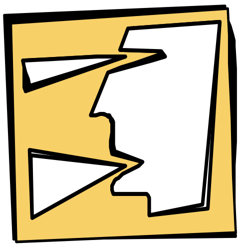


**Table 3: Suggested minimum requirements: performance standards**

| OBJECTIVE | INDICATORS | PERFORMANCE STANDARD |
|---|---|---|
| **Outreach: depth** | 1. Average loan size | Must be below the annual per capita income of the country |
| | 2. Percentage of women | 1/3 to 2/3 of loans disbursed and 1/3 to 2/3 of the total value of the loan portfolio |
| **Scale** | 3. Number of borrowers<br>○ Loans disbursed<br>○ Outstanding loans<br>4. Growth in number of borrowers<br>5. Market share: borrowers as a percentage of population living in region | |
| **Sustainability: Portfolio quality** | 6. Portfolio at risk<br>Balance of loans over 30 days late divided by total outstanding loans | Must be under 10 % |
| | 7. Loan loss ratio<br>Annual loan losses divided by average outstanding loans | Must be under 4 % |
| **Self-sufficiency** | 8. Level 1: Operational self-sufficiency (income covers operational and risk costs) | Within 3 – 7 years |
| | 9. Level 2: Financial self-sufficiency (income covers operational, risk and capital costs) | Within 5 – 10 years |
| **Efficiency** | 10. Interest margin:<br>Operational and risk costs divided by average outstanding loans | 25 % - 35 % |
| **Productivity** | 11. Staff productivity:<br>Number of outstanding loans divided by number of loan officers | Minimum of 100 borrowers |

## Step 9: Evaluation of the impact

After a credit cycle is completed, an external party evaluates the impact of the credits on the business level as well as on the household level. Typical questions could be:

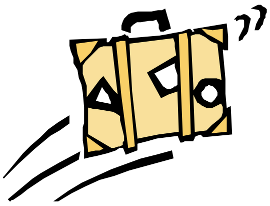
- After taking credit, did your income increase/decrease?
- What, if any, improvement did you experience in your business activity?
- Were new jobs created as a result of business expansion?
- What, if any, improvements of the conditions of the family did you experience?

## Step 10: Monitoring and evaluation of the intermediary

The intermediary is monitored and evaluated regularly as described in 8 above.

# Establishment of a Credit Programme

## References and Sources Used



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