Micro-credit Programs:
Key Characteristics and Design Considerations

Report to the Black Creek Community Capacity Building Project—Microcredit Working Group

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PART I: Overview of Micro Credit Program Objectives and Characteristics

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I.1 Introduction

This reports catalogues key characteristics of the micro credit-lending model (Part I) derived from a survey of various types of micro credit lending programs (Part II) and presents a series of questions intended as a guide to the design of such a program (Part III). The programs surveyed are listed below. With the exception of the Grameen Bank program—included here for comparison purposes given its high international profile and leader-model status—the programs surveyed have been operating in Canada, predominantly Ontario. In cataloguing the characteristics and profiling this representative set of programs, we hope to inform best the choice of an appropriate micro finance model for the Black Creek Community.

I.2 Programs Surveyed:

Calmeadow Program (Toronto and Nova Scotia, Canada); 1987-2000.
Ottawa Community Loan Fund (City of Ottawa, Canada); ongoing. Size: $500,000 (July 2005)
Riverdale Community Loan Fund (Riverdale, Toronto, Ontario, Canada); ongoing.
Stepping Stone Loan Program (Sudbury, Ontario, Canada); ongoing.
Grameen Credit Model (Rural Bangladesh); ongoing: 1976 – present.

I.3 Definitions and Assumptions

Microcredit is a financial service offering small loans to people who have difficulty accessing credit through the traditional banking sector. In a country such as Canada, with a well-developed banking system, this difficulty arises because some people do not meet the necessary financial preconditions for a traditional loan due to a lack of collateral, lack of steady employment, or lack of a verfiable credit history (as would be the case with new immigrants, for example) but who are otherwise creditworthy as evidenced by a good business plan, good moral character, and the like.

It is assumed that there exist community members who are ineligible for traditional bank loans for reasons unrelated to their ability and commitment to fulfill their financial obligations and who would derive a longer term economic benefit from a small advance of funds. An advance of funds can offer a borrower a financial “leg up” by offering him or her the necessary start-up capital to engage an income-earning activity and as such well-managed debt is a potentially useful instrument for economic development. The risk to both the borrowers and the providers of such loans is, however, the risk of the borrower falling into a “debt trap”, that is, borrowing to service or pay off previous debt and so such loan programs must be carefully monitored.

I.4 Micro Credit Objectives

The fundamental or overarching objectives of micro credit programs are:

- To promote employment in the area for the benefit of the community.
- To promote local economic development by promoting trade and industry in the area for the benefit of the community.

Programs vary in what subordinate objectives are chosen to meet these overall goals. For example, specific program goals may be to help women become economically independent, or to help new immigrants establish themselves in the community. As such, these programs are designed to promote economic self-reliance in which either individuals or community groups become less reliant on state sources of income support.

At its core, the micro credit program differs in the manner in which the micro credit programs assess creditworthiness of potential borrowers. Where traditional financial firms rely exclusively on methods of systematic credit scoring to assess potential risks of default, the micro credit program, as a community-based program, has access to important qualitative information about an individual's or group's moral character and potential for a local business success. The qualitative, character-based lending of the micro credit program thus differs fundamentally from the quantitative, portfolio-based lending of the traditional financial firms.

Given these objectives and fundamental distinctions, the key question motivating this study is, ***how does Micro credit operate to mobilize funds to promote community development?***

To examine the various ways in which a given program might answer this question, we consider

1. borrower characteristics,
2. sources of funds,
3. relationship between the borrower and the micro credit loan program,
4. nature of the loan agreement, and
5. types of funded projects.

I.5 Organizational Status

Typically, the organization in charge of constructing and monitoring the micro fund, may be set up in a number of different ways- for example, it can either be "for profit" or "not for profit", formal or informal, set up as a registered charity or not.

*A **Credit Union*** is an example of a formal, not-for-profit, non-charitable organization. It is a unique member-driven, self-help financial institution that comprises of members of a particular group, who agree to save their money together and make loans to each other at reasonable rates of interest. It is a democratic, not for profit financial cooperative, that is owned and governed by its members, with members having a vote in the election of the directors and committee representatives.

*A **cooperative*** is an example of an informal, not-for-profit organization that may be charitable or not. It is an independent association of persons united voluntarily to meet their common economic, social, and cultural needs through a jointly owned and democratically controlled organization.

A ***Community Bank*** is a formal, for-profit, non-charitable, corporation.

I.6 Borrower Characteristics

Borrowers in the programs we surveyed exhibited the following characteristics:

- were unable to access traditional lending facilities without assistance, possibly for the reasons cited above;
- had some connection with the community (e.g., a resident);
- had a clear plan (business proposal) to spend the funds on a project that has the prospect of generating the income with which to pay off the loan; and
- Were variously individuals with an idea for a single proprietary enterprise, groups of individuals with a proposal for a partnership, or incorporated small businesses.

I.7 Borrowers of Funds

Borrowers of funds are typically individuals, groups of individuals, and small and medium sized enterprises (SME's).

A micro finance project that identifies the ***individual*** as its primary borrower, may distribute loans to individuals directly without the individuals having to first organize themselves in groups, or become a part of an association, etc. This model of individual lending/borrowing is normally part of a bigger "credit plus" program where other outreach services such as skills development, education, etc. are also provided.

Alternatively, individuals may decide to organize themselves in a ***group***.The group model's basic philosophy lies in the fact that shortcomings and weaknesses at the individual level are overcome by the collective responsibility and security afforded by the formation of a group of such individuals. The collective coming together of individual members is used for a number of purposes: educating and awareness building, collective bargaining power, peer pressure etc. The Group model is closely related to, and has inspired, many other lending models. These include community banking, village banking, self-help, solidarity, peer pressure, and the like.

Lastly, borrowers may be ***small and medium enterprises (SME's*)**. Typically, micro credit programs have focused relatively greater attention on SME's, since business ventures have the greatest potential of generating the income necessary to repay the loan, have the greatest potential for generating employment in the community, and typically provide services that are needed in the community. Supports that accompany micro credit loans to SME's typically include systems such as training, technical advice, management advice, etc.

I.8 Providers/Sources of Funds:

Funds to support the program are provided by either by the community members themselves or institutions external to the community.

Internal sources of funds are generated by amassing local savings, mobilized through either informal peer lending arrangements (idiosyncratic contractual arrangements amongst peers), or through more formal institutional arrangements (with standardized savings contracts exchanged by unfamiliar parties).

The ***Rotating Saving and Credit Association (ROSCA's)*** is an example of how a funds maybe generated from within the community. Here, a group of individuals come together and make regular cycle contributions to a common fund, which is then given as a lump sum to one member in each group. For example, a group of 12 persons may contribute $10/month for 12 months. The $120 collected at the end of each month is then given to one member in the group. Thus, a member will "lend" money to other members in the group through her or his regular monthly contributions, and after having received the lump sum amount when it is his turn (i.e. "borrow" from the group"), she or he then pays back the amount in regular/further monthly contributions. This model forms the basis for the peer pressure and Grameen bank.

Peer pressure is a commonly used model in which the borrower's moral and his or her relationships with other participants are utilized to ensure repayment and active participation in the micro credit programs. A peer group is formed by the members of the society who are in need of funds. In a peer group, the members of the group do not receive loans unless the initial borrower of the group repays the loan. Therefore, there is peer pressure on the borrower to repay the loan on time, thus ensuring low default rate.

Alternative measures of 'pressure' such as frequent visits to the defaulter by the loan officer, community meetings in which the borrower is identified and requested to act in accordance with the community, etc could also be exercised.

Examples of sources of funds generated **external** to the community include *non-governmental organizations (NGOs),* which use donor funds and other external funding sources to support community development programs; and *community banks,* where the entire community is treated as a single unit. Here, formal or semi-formal institutions (such as local banks) are established through which funds for the project are collected and dispensed.

I.9 Role of Micro credit—the relationship between the borrower and the provider of funds

With the borrowers and the providers of funds identified, the particular relationship between them may take a few different forms, varying in the nature and extent of the fund's financial commitment to the borrowing population and in the nature of the expertise required to manage the program.

The program may use the funds to lend directly to the borrowers as **seed monies,** thus operating as a lending facility separate and distinct from, but complementary to, the traditional banking sector. The advantages of this relationship include the fact that the program is entirely within the control of the managers and so the goals of the program are directly influenced by the decisions of the managers, hence the likelihood of establishing and enhancing cooperative community relationships are highest. The disadvantages include the fact that borrowers do not have the opportunity to establish a credit history in the mainstream financial sector. Expertise required in this model includes the ability to assess and monitor loans, creditworthiness of clients, process and administer loans.

The program may instead use the funds as **guarantee funds**—that is, funds to guarantee loans from traditional banking sources, thus providing the collateral necessary to allow the borrower direct access to mainstream financial services. The source of funds for the *guarantee* can be either external or internal. It is arranged externally via donations, government agency, etc., or it maybe be done internally by using member savings. The loans thus obtained may be given out to a self-formed group, or directly to an individual. The advantages and disadvantages of this program are the converse of the direct lending arrangement. In particular, the advantages include the fact that borrowers now have the opportunity to establish a credit history in the mainstream financial sector. Expertise here is primarily the ability to manage a portfolio of low risk financial assets and assess creditworthiness of prospective borrowers in collaboration with an established lending institution.

Finally, the program may be used to fund the support services designed to **educate, advise** on such items as developing a business plan**,** managing a business, or monitoring and administering loans as a **trustee** operating in a fiduciary capacity for the borrower once she or he acquires funds from the traditional or mainstream sources. In some cases, microfinance pays a crucial role by creating credit awareness among borrowers by introducing them to various types of savings programs, thus making them more attractive to the lenders.

I.10 The Primary Types of Projects Funded

The principal types of projects funded are:

- To start or expand business operations -- purchasing inventory, buying production equipment, and promoting an existing business. Examples: purchasing computers, sewing machines, supplies, inventory, as well as other promotional and advertising materials.
- To pay for education and training of individuals in a new skill that will help them to find a job.
- Creating Self-employment for income generating activities, and housing the poor.
- In no case is a loan approved for consolidating existing debt

I.11 The Nature of the Loan Agreement

For those programs that have established a direct lending relationship with the borrower, micro finance will serve to guarantee loans, and the nature of the loan agreement will define the parameters under which the programs run. The loan agreement typically covers all or most of the following terms: Denomination/Principal, Interest Rate, Duration of the Loan, Repayment schedule, and Default contingencies.

Of the programs we surveyed the majority of loans were small ($500 - $15,000), short term (payable in 1-5 years) loans, with an exceptionally high expected repayment rate (97% and higher). A related feature of these programs is often a graduated funding eligibility—with the successful discharging of a small ($500, e.g.) initial loan, the borrower becomes eligible for a larger loan ($1000 then $1500, e.g.)

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PART II. Details of the Microcredit Programs Surveyed
by Varun Dua and Swetha Subbiah
(See Appendix B "Highlights of Existing Microcredit Programs for an Overview)

II.1 THE CALMEADOW LOAN PROGRAM

Operating Area – Toronto, Ontario and Nova Scotia, Canada

1. **Goals** – To provide access to credit for financially challenged entrepreneurs through loans and support services.

2. **Purpose**-To provide loan opportunities to self employed individuals in a cost-efficient method and effectively utilizing the revenue earned from loan portfolios towards the operating costs

3. **Organization Status-** NA

4. **Employee Status-** NA

5. **Type of Credit Lending Model-** NA

6. **Approach**-
   - It uses the peer-lending model and the escalating scaled-loan system.
   - Individuals come together to form "business credit groups" where they evaluate each other's business plans and offer advice to each other. It is based on the Grameen Credit Delivery System and promotes fiscal responsibility within the peer-group, thus offering loans by using the group's own interest

7. **Target Market-** NA

8. **Source of funds-** NA

9. **Use of loans / funds** – NA

10. **Criteria / Eligibility for loan approval**- NA

11. **Loan Approval Process**-
    - Members of the "business credit groups" evaluate each others application.
    - Individuals character and ability to pay back the loan is assessed by the other group members
    - Once approved by the group, the individual may receive up to three incrementing loans.
    - In case of delinquency in loan installments by any group member, no additional loans were approved within the group

12. **Types of Loan & Amount of Loan**– NA

13. **Duration of Loan** – NA

14. **Expected Repayment Rate-** NA

15. **Return on Investment-** NA

16. **Loan Agreements/Contracts-** NA

17. **Default Risks-** NA

18. **Incentives for Investors-** NA

II.2 OTTAWA COMMUNITY LOAN FUND (OCLF)

Operating Area – City of Ottawa

1. **Goals** – To help more people become self-sufficient through self-employment.

2. **Philosophy** - OCLF believes in investing locally by encouraging the business and career dreams of individuals in Ottawa. They also believe everyone deserves a chance to make a brighter future for their families and themselves.

3. **Organization Status** – Charitable

4. **Status of Employees** – Volunteer & Paid

5. **Type of Credit Lending Model** – Bank Guarantee.

6. **Approach** – OCLF functions under the traditional approach where credit histories and tangible assets are some of the elements considered for granting financing. It takes an additional step in this traditional formula and broadens the approach by also taking into consideration the character, talent and ability of the applicant.

7. **Target Market**-
   - Their primary borrowers are individuals, businesses and groups with worthwhile business concept, practical work experience or training, and a good business plan.

8. **Source of funds-**
   - The OCLF has established a community lending partnership with several financial organizations, thus increasing their ability to assist individuals and businesses in obtaining financing for their start-ups, expansion, or accreditation training.
   - OCLF provides guarantees to institutions such as Ottawa Women's Credit Union (OWCU)
   - Others lending partners include CYBF, BDC and Dick Stewart Fund for people.

9. **Use of funds** – To start or expand business operations and not use the funds to consolidate debts

10. **Eligibility for**-
    a) Small Business Loans:

- 18 or older & have permanent legal status in Canada
- Sole ownership in the company or have partners that are willing to co-sign for the business loan.
- Satisfy the OCLF committee that the loan will be fully repaid.
- The applicant can submit a complete business plan including start-up or expansion costs, and a cash flow forecast.
- Have attended the OCLF training program or have experience in running a small business.

b) Internationally-Trained Professional Loans:

- If the applicant has been accepted or recommended by a recognized accreditation program for Internationally-Trained professionals.
- Satisfy the OCLF committee about the full repayment of loans.
- 18 years or older and have permanent legal status in Canada.

c) Canadian Youth Business Foundation Loans:

- The individual is between 18 – 34 yrs old and is eligible to work in Canada.
- Produce a strong business plan and have related training or experience related to the business idea.
- Agree to work with a mentor for the duration of the loan term (3 – 5 years)
- For a partnership of two, the principal or general partner must meet the age criteria and both are subject to the CYBF application process
- If the business is incorporated, the applicant must be a majority shareholder, having at least 51% of the voting shares, and be involved in the day-to-day management of the business.

11. **Loan Approval process-** NA

12. **Types of Loan & Amount of Loans** – Short-term loans up to $15,000

13. **Duration of Loan** – 3 to 5 years

14. **Expected Repayment Rate-** NA

15. **Return on Investment-** NA

16. **Loan Agreements/Contracts-** NA

17. **Default Risks-** NA

18. **Incentives for Investors**-

It helps these community based financial institutions to obtain new members.

- OCLF also provides loans to Internationally-Trained Professionals particularly new immigrants.
- It also gives loans to Social Enterprises and Coops.

II.3 RIVERDALE COMMUNITY LOAN FUND

Operating Area – Greater Riverdale Area in Toronto

1. **Goal** – Provide financial help to local business

2. **Philosophy** – Contributing to the community by helping people become self – sufficient through self employment.

3. **Organization Status** – Charitable

4. **Employee status** – Volunteer

5. **Type of Credit Lending Model** – The credit lending model used in this loan fund is that of a bank guarantee. It is a form of Capital guarantee scheme where ACCESS Riverdale funds are used to guarantee loans through Alterna Savings

6. **Approach** – A 'step – lending' approach is used by this community loan fund to provide a series of loans that increase in size as the business grows in the community

7. **Target Borrowers** -
   - Primary Borrowers are entrepreneurs who recently started a small business and may have poor or no credit history in Canada due to unemployment or illness.
   - Secondary borrowers are few individuals who borrow money for their personal use.

8. **Source of funds** – Funds are collected through donations and Investments made by individuals, organizations and businesses.

9. **Use of loans / funds**-
   - Small businesses use the loan to purchase inventory, buy production equipment, and increase their marketing.
   - Individual use the funds for personal use such as educating themselves in a new skill which will help them to find a job.

10. **Criteria / Eligibility for loan approval**-

Loans are approved using a character based lending decision with the following aspects in mind-
   - Commitment, reliability & character of the applicant
   - Applicants relevant skills and abilities
   - Capability of the business & worthiness of the loan
   - Applicants ability to manage loan payments

11. **Loan Approval process**:
   - The applicant fills out the loan application form and submits supporting documents such as business plan, training certificates, licenses, leases, etc.
   - Individual is interviewed by committee members
   - Loan Review Committee decides whether the candidate is approved or declined.

12. **Types of Loan & Amount of Loan** – Initial loans of up to $5000

13. **Duration of Loan** – Payable within 18 months

14. **Expected Repayment Rate** – 97%

15. **Return on Investment**: 0-5%

16. **Loan Agreements/Contracts**: This contains the appropriate interest rate to be paid by the borrower during his monthly instalments. The contract will also contain the necessary default conditions.

17. **Default Risks** – A loan loss reserve equal to minimum 20% of the amount on the loan is used to cover loan defaults

18. **Incentives for Investors / Donors**-
    - Investors can invest for 1 – 3 years and receive 0 – 2% interest on their investment.
    - Investors also avoid high investment fees and unstable financial markets.
    - Individuals willing to donate will receive charitable tax receipts and will be updated regularly on the loan fund.

II.4 STEPPING STONE LOAN PROGRAM

Operating Area – Residents from the city of Greater Sudbury

1. **Goals** – To promote team-building, group co-operation, and ongoing support in the community.

2. **Philosophy** – The program offers small business loans to self-employed micro-entrepreneurs.

3. **Organization Status-** NA

4. **Employee Status** – Volunteer & Paid

5. **Type of Credit Lending Model** – Peer-lending Model

6. **Approach-**
    - 4 to 7 people come together to form a peer circle that completes the training, meets monthly to exchange advice, provide support and to assess each other's loan applications.
    - Unlike traditional bank lending, the members of the peer circle are responsible for the loan approvals.
    - A decision is made based on an applicant’s character and capacity to pay back the loan.
    - The Stepping Stone Program is an alternative self-employment training program based on a Peer Lending model.

7. **Target Market** – Individuals and businesses

8. **Source of funds** – Credit Lending partners such as individual and financial institutions.

9. **Use of loans / funds** - These loans can be utilized to finance many entrepreneurial activities, such as purchasing computers, sewing machines, supplies, inventory, as well as other promotional and advertising materials

10. **Criteria / Eligibility for loan approval-** NA

11. **Loan Approval process**- NA

12. **Types of Loan & Amount of Loan**-

The loans range from $500 to $3000 and are available in three steps:

- 1ST STEP – up to $1000
- 2nd STEP – up to $2000
- 3rd STEP – up to $3000

13. **Duration of Loan** – 1 to 5 years

14. **Expected Repayment Rate-** NA

15. **Return on Investment-** NA

16. **Loan Agreements/Contracts-** NA

17. **Default Risks-** NA

18. **Incentives for Investors-** NA

E. <u>GRAMEEN CREDIT MODEL</u>

Operating Area – Rural areas in Bangladesh.

1. **Goals** - Its mission is to help the poor families to help themselves to overcome poverty. It is targeted to the poor, particularly poor women

2. **Philosophy** – To promote Credit as a human right. Grameen Credit is based on the premise that poor have skills which remain unutilized or under-utilized.

3. **Organization Status** – Profitable , Private organization

4. **Employee Status** – Paid

5. **Type of Credit Lending Model** – Grameen

6. **Approach**-
   - It is based on trust and not on any legal procedures or contract.
   - Grameen credit is based on the premise that the poor have skills which remain unutilized or under-utilized

7. **Target Market** – Poor families, particularly poor women

8. **Source of funds-**
    - Loans are primarily given through non-profit organizations or through institutions owned primarily by the borrowers.
    - If it is done through for-profit institutions not owned by the borrowers, efforts are made to keep the interest rate at a level which is close to a level matching with sustainability of the programme rather than bringing attractive return for the investors.

9. **Use of funds-** Creating Self-employment for income generating activities, and housing the poor.

10. **Criteria / Eligibility for loan approval**- Borrower must join a group of borrowers

11. **Loan Approval process**-
    - A bank unit is set up with a Field Manager and bank workers; this unit covers an area of about 15 to 22 villages.
    - The unit starts by visiting villages to identify the prospective clientele and also to educate the local population about the purpose, the functions, and the mode of operation of the bank.
    - Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan.
    - Only if these two borrowers repay the principal plus interest over a period of fifty weeks do the other members of the group become eligible themselves for a loan

12. **Amount of Loans-** NA

13. **Duration of Loan-** NA

14. **Expected Repayment Rate** – 99%

15. **Return on Investment-** NA

16. **Loan Agreements/Contracts**-
    - Interest rates will be less than the standard market rate.
    - Loans can be received in a continuous sequence. New loan becomes available to a borrower if her previous loan is repaid.
    - All loans are to be paid back in instalments (weekly, or bi-weekly).

17. **Default Risks-** NA

18. **Incentives for Investors-** NA

PART III. Next Steps: Questions to help define the Micro finance model[1]
By Swetha Subbiah and Varun Dua

1. **What is the goal of the program?**
   - Could be to provide financial help to local for-profit businesses
   - Help individuals become self-sufficient; to start local cottage industries, etc.
   - Build community infrastructure (but these projects must generate some income to the borrower from which she or he can pay off the loan)
   - Promote team building, group cooperation, on-going support to communities

2. **What is the purpose/philosophy?**
   - Whereas goals are normally defined in economic terms, the philosophy/purpose involves a deeper thought process. It throws light on the fundamental reasons / ideologies behind setting up a micro finance project.
   - For example the philosophy behind the Grameen Credit Program is to "Promote credit as a human right - the belief here is that people have skills that they may not be able to develop or utilize due to the lack of finance."

3. **What is the Organizational status?**
   - For profit
   - Not for profit

4. **What role will Microfinance play?**
   - It could be one where microfinance program is an intermediary with an active lending role as with a community loan program, i.e. interviews potential candidates, lends funds, monitors the progress of individuals/business, places checks to ensure repayment.
   - Alternatively, the role of the micro finance could be a more passive one where the micro fund is merely pool of funds that acts as a guarantor for bank loans, etc
   - Finally it could play the role of agent/advisor/facilitator in the lending process.

5. **What are the Sources of funds?**
   - Internal from within the community
   - External from an outside source

6. **What types of projects will the program support?**
   - What type of projects the fund might invest in (this should be reflective of the goal).

7. **Who are the borrowers?**
   - As mentioned earlier, borrowers could be individuals, peer-lending groups or small and medium sized businesses

8. **What will be the size or denomination of the loan?**
   - A related question could be, if this loan amount increases overtime, and if so what would be the criteria for increasing the amount?

9. **What are the lending/borrowing criteria, or how can become eligible to receive these loans?**
   - Borrower might have to join a group of borrowers (peer-lending)

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[1] Adapted from notes to the presentation "Microfinance: An Overview" by Varun Dua and Swetha Subbiah (Appendix A)

- Submission of a complete business plan
- Attend a training program

10. **What will be the duration of Loan (term)**
    - Payable within 18 months (Riverdale)
    - 1-2 years (Stepping Stone lending program)
    - 3-5 years (OCLF)

11. **What are the indicators of success?**
    - Indicators of success are defined by the goals of the project
    - If the goal is to reduce unemployment, then a good indicator would be the percentage change in the unemployment rate.
    - Other indicators could be the increase in the number of businesses within the community, etc
    - One commonly used indicator is the repayment rate; the rational being that if one is able to repay his/her loan, he/she has been successful (but this is not the best indicator- E.g. Bangladesh were women got into debt traps, taking loans elsewhere to repay micro credit loans).

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Appendix A: Microfinance—An Overview. May 14, 2007
Appendix B: Highlights of Existing Micro Credit Programs