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Prevalent Microlending Methodologies in the LDCs

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Abstract

This paper provides an outline of the diverse programme structures and operational methodologies adopted in the LDCs by microlending institutions today. There are several distinct models of popular microlending methodology, which were in operation even in the West . Among them, the Grameen Bank model may be the most well known. Over the past three decades, older microlending methodologies have been tested and new methodologies developed. 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 programme. It has become clear to practitioners that there is not one correct microlending model, or even one correct model in a given operating environment.

Background

During the 1970s, most of the low-income countries of the Asia-Pacific region and in Latin American countries incorporated the concept of microfinance within their mainstream financial systems. In the early seventies, the targeted and subsidised rural credit models were dominant. The commercial banks both private and mainly the government banks have been engaged in microfinance activities. But the trend showed that most of the conventional banks became failure because they were government-mandated and they had to lend with subsidised rate of interest due to the lack of free interest rate policy. But some government-mandated banks, who are charging commercial rate of interest, are found commercially viable. The famous banks like Banco Wiese of Peru in Latin America, BancoSol in Bolivia and Scotia Enterprises in Guyana are some of its examples. These banks, started from non-government organisations (NGOs) programme, were the first microfinance institutions to transform into a commercial bank and they are still providing microfinance services profitably.

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History of Microlending Approaches

The practice of microlending is not new. Credit cooperatives and charities making loans to young entrepreneurs can be found in 18th century Europe. An 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" (Hollis et al., 1998, cited in Brandt, Laura et al., n.d.). Another example is the fund created by 18th century novelist Jonathan Swift who donated £500 of his own wealth for lending to "poor industries tradesmen in small sums of five, and ten pounds to be repaid weekly at two or four shillings without interest" (Sheridan, T., 1787, cited in Brandt, Laura et al., n.d.)

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 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 (Prescott S., 1997).

The "Bread Association created by a priest Raiffeinsen in Germany in 1846 was another manifestation of microcredit movement when the local farmers remained indebted mostly depending on the usurious moneylenders. The priest granted them wheat flour so that with the making and commercialisation of bread, they could earn income to reimburse the debt and constitute capital for their further businesses. However, all modern days' microlending models can be broadly classified into two general categories: individual lending and group or peer lending module.

(i) Individual Lending Programme

The individual approach is most commonly associated with commercial banks. In this category, loans are given to individual borrowers. The bank performs a thorough analysis of every potentially funded business venture. Borrowers receive loans based on collateral and co-signers, past performance, credit histories and viability of business propositions. Lending provided by village moneylenders, or by specialised development banks and commercial banks are based on individual lending philosophy, which includes collateral or co-signers' guarantee. This is a straightforward credit-lending model where loan is directly given to the borrowers without forming the group or generating peer pressures to ensure repayment. The individual lending model possesses a long history in the study of financial system of a country and has been applied most successfully to urban clientele rather than to rural clientele.

(ii) Group (Peer) Lending Programme

On the other hand, peer lending or group lending, or solidarity model is a gradual modification of Rotating Savings and Credit Associations (ROSCAs) operated effectively in different countries in the form of informal source of finance. In this model, there is a peer group linkage between the borrowers and the peers to ensure loan repayment in microfinance programs. Mutually guaranteed loans with other borrowers, screening of potential clients by their peers, client's closeness with peers rather than with programme staff are the basic features of peer lending modality. Just as individual lending programmes disburse loans to individuals, group lending programmes also disburse loans via groups. In this case, group members guarantee the repayment of each other's loans. Collateral and co-references are not used. Peer pressures and group liabilities take their place on peer assessments of each other's businesses. Professor Muhammad Yunus made clear about these terms as "formation of small five-member groups of the members' own choosing and federating the groups into centres helps to create right kind of peer pressure at the time, when a member tries wilfully to violate Grameen Bank rules, and peer support at times, when a member falls into any difficulty in pursuing his economic pursuit" (Yunus, 1993: 3).

Peer lending model also can be grouped into two headings: (a) solidarity groups and (b) community based organisations. In solidarity type, groups are formed and size of group may vary. Solidarity models are either Grameen type (group of 5 persons) or Latin American type (group of 5 to 15 members) which is rather flexible. Grameen replications in Nepal mainly fall in the solidarity group model. Group formation is based on the principle of joint liability and homogeneity and it is a loan security and guarantee mechanism. Several practices have shown that this model is based on the principle of *group dynamism*, which has three processes: (a) organising to a group from like-minded people within a settlement with an objective of their overall development, (b) group cohesiveness, which needs organisation, savings and skill generated from social mobilisation and (c) third is the conversion of their savings into some skill. Thus leadership development, ownership, resource utilisation linkage development, and the networking forum are the essential elements of group dynamism. Actually, the group dynamism is a quality of microfinance that encourages transferring the management and ownership to the groups/cooperatives after becoming the clients self-reliant.

Operational Structure of Individual and Group lending Module

Individual and group methodologies require different structures of operational and financial organisation. It is important for the most appropriate structure to be selected based on organisational 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. But 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. Therefore, 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 organisation to evaluate these trade-offs when deciding on a methodology.

Group Lending Approaches

Unlike individual lending programmes, which tend to generally follow the same approach, there is wide methodological variation among group lending programs. The Village banking, Grameen banking, solidarity model, self-help model, peer pressure model, and savings and credit organisations (SCOs) lie under the group-lending model as shown in the following scheme cited from the "CARE Savings and Credit Sourcebook CARE, 1996.

Solidarity Group vs. Community-Based Organisation Approaches

Regarding group model characteristics, the programmes can be subdivided into Solidarity Group approaches and Community-Based Organisation (CBO) approaches. The distinction between the Solidarity Group and the CBO approach has to do with the desired future relationship between the lending body and the borrower group. The CBO approach has 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 independent of the lending institution owned and managed entirely by the poor. In contrast, the Solidarity Groups are those programmes that do not anticipate the eventual graduation of the borrower group from the lending institution. Participants are considered long-term "clients of the programme (Waterfield et al., 1996 cited in Brandt, Doc. (n.d.) No. 53). Below is the discussion of Solidarity Group model, which can be divided into two categories.

Grameen Bank Model

Over the last three decades, Grameen Bank (GB) approach appeared as a popular model for poverty alleviation. *Grameen*, which comes from the word village, provides credit to poor women to acquire assets for self-employment. Muhammad Yunus propounded this model as a simple act of trust in lending without collateral with minimal conditions. He realised that the existing economic and commercial banking system is never intended for the poor as it has two main hurdles, i.e. guarantor and collateral.

Certain characteristics of the GB differentiate it from other poverty alleviation programmes. It provides loan for poor women, who occupy a large share among the poorest using loan eligibility criteria as 0.50 acre of land. Small and manageable loan amounts, weekly repayment system, savings mobilisation scheme, and autonomy are the special characteristics in this grassroots-based Grameen organisation. The bottom line of the GB's success lies on the fact that-- firstly it has developed close relationship between bank and borrower, and among the borrowers themselves. Secondly, peer pressures and peer supports are important tools in putting the clients into right track in pursuing their economic activities and in timely repayment of loan. In addition to repayment requirements, the Grameen Bank incorporated strong social requirements into its programme, which are 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. The Grameen model has received worldwide attention as it works best in densely populated rural areas with a static population.

But critics have doubted about the effectiveness of these methodologies on the ground that the group members cannot always ensure for the default loans. It is important only for the first few loan cycles, and thereafter it becomes irrelevant (Wright, 2000 p.52). Critics also remarked about the main features of Grameen, i.e. group size, weekly savings, weekly

repayment, and regular attendance in the weekly meetings considering them as restrictive factors to reach into the very poor community. The very poor clients often do not have the capacity to manage fund and to repay the loan resulting negative impact. But these days, most of the Grameen type microfinance institutions have changed the weekly meeting arrangements into fortnightly transactions. Early microfinance programmes in Bangladesh were also proved ineffective in mobilising savings moving close towards self-sustainability. Savings schemes are now compulsory for every member,. which is accumulated in Group Fund. But now the Group Fund also is replaced by Grameen II or modified Grameen.

Modified Grameen Model

Grameen Bank (GB) gained a lot of experience through its success and failures. It incorporated many new features in its methodology to address various crises and problems like the flood of 1998 that made loss of all possessions including houses of the Grameen borrowers like many other people of Bangladesh. The GB started issuing fresh loans for restarting income generating and to repair or rebuilding their houses. Borrowers and their family demanded to withdraw the "group tax" or the component of "group fund" at the time of leaving the bank. For some period borrowers fell off the track and did not pay the loan instalments. In 14 April 2000, the GB implemented a new system, i.e. the Grameen Generalised System, which is called Grameen II or second-generation microfinance institution. It includes a single prime loan product called "basic loan" with two other loan headings, i.e. (a) housing loan and (b) the higher education loan replacing all the features of Grameen Classic System. It has replaced general loan, seasonal loan, family loan group fund, branch-wise, zone-wise loan ceiling, fixed size weekly instalment etc. (Yunus, 2002 :6-7).

Yunus described this basic loan as "Grameen Microcredit Highway." In this system, if a borrower faces some trouble (Business slow-down/failure, sickness, family problems, accidents or natural disasters) and cannot keep up with the high way speed she (client) has to quit the highway and take an exit on to a detour called a "flexible loan" that way she can reduce the instalment size (affordable to pay) by extending the loan period. Some encouraging features, like pension fund, loan loss provisioning and write off policy, loan insurance (for both borrowers and enterprises) are included in the modified system.

Latin American Solidarity Group Model

In the early 1980's, loan programmes 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 programmes. 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, e.g. analysis of each client's loan request 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, and the institutions which follow this model, often offer only credit services (Waterfield et al., 1996).

An interesting example of Solidarity Group model is BancoSol, located in Bolivia, a chartered bank. It makes collateral free 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 this bank 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 (Glosser, 1994). 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 the bank are located in urban areas. BancoSol uses the Americans for Community Cooperation in Other Nations' (ACCIONs) group lending methodology, i.e. *"cover the costs first*. It means borrowers pay interest enough to cover the expenses of making other loan.

Community-based Organisation Approaches

The community-based organizations (CBOs) are that type of NGOs, which do not perform any microfinance activities. Actually, these organisations are the modifications of the ROSCAs, the short form of rotating savings and credit associations that are very informal. Out of two types of NGOs operating, one is financial intermediary type known as financial intermediaries (FINGOs), and the other is social intermediary known as SFINGO that does not perform any microfinance activities. These SFINGOs are the community-based organizations in the real sense. Microlending models using the CBO approach can be divided into two subgroups: Community-managed Loan Funds and Savings and Loan Associations. The distinction between these two models is:

- Community-managed Loan Funds receive initial funding from outside the organisation (in the form of a loan or grant). There are two main approaches to community-managed loan funds, i.e. Village Banking and Revolving Loan Funds.
- Savings and Loan Associations generate all funds internally (through member savings or retained interest) and receive no external funding

Village Banking

Village Banking is probably the most practiced kind of Community-Managed Loan

Fund. This model is an informal bank for non-collateral loan to members in a community; and the community will be responsible in handling the credit directly to individuals. The Village Banking model was first developed in Bolivia, the Latin American country by the Foundation for International Community Assistance (FINCA) in the mid-1980s. The FINCA is a U.S. based non-profit organisation specialised in rural credit programmes. The programmes using this methodology have been widely replicated in different parts of the world by other NGOs throughout the Africa especially reaching to poor segments of the society in rural areas. Village banks, the community-based savings and credit associations are closely related to community banking consisting of 25 to 50 low-income individuals mostly women (Nelson et al., 1994). Initial loan capital for the village bank comes from an external source. But, members themselves collect payments and savings through their own by-laws. This model has evolved in Asia, Africa, Latin America and in the Middle East.

The principles and standards were enunciated in the first International Conference for practitioners of village banking in 1994. Targeting the poorest from women, democratic type of management and structure, credit linked with savings (members must save in order to borrow), are the main principles and standards. But they have changed their savings policies from original model or they have moved from "forced" to "voluntary savings" adopting more flexible approaches. Further, in Latin American village banking model, loan ceilings are not fixed as they determine it on the borrowers' capacity to repay and available programme funds.

Self-reliant Village Banking Model

Self-reliant village banking model was developed in Africa, where population density is low, similar to the hills of Nepal. Self-reliant village banks are established and managed by a rural village community. This model differs from village banks only on one ground that it meets the needs of the village as a whole and not just a group of 25 to 50 people. The French NGO, the Centre for International Development and Research (CIDR) developed this model in the mid-1980s.

Community-Managed Revolving Loan Funds

The Community-Managed Revolving Loan Fund (RLF) 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 channelled directly to the fund, 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:

- 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. When initial funds are provided as a loan, the repayment period is usually long (at least 2 years) (Waterfield et al., 1996). After the initial grant or loan, additional funding is usually not provided.
- 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) (Waterfield et al., 1996).
- Member savings, though required for all members in the initial period, may not be required after the initial period.
- Peer pressure is the primary means to guarantee repayment, but RLF groups may chose to require some form of collateral.

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 SLA comes from member savings and equity contributions only, and no outside funding is accepted. Savings and Loan Associations are always entirely financially independent of outside institutions, even in the start-up period. Development institutions and NGOs may contribute technical assistance and training in the start-up period, but loans are always financed entirely by the member base. Groups usually consist of between 30 and 100 members. Savings mobilisation 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 capitalise group funds (Waterfield et al., 1996).

Other Models

Besides this broad classification of microfinance models in the global context, i.e. individual and group lending model, there are other modalities applied in the field of microlending. Below is the discussion of some other models.

(a) Rural Credit Union Model

Credit union is a cooperative financial institution owned and run by its members, who agree to save their money together and make loans to each other at reasonable rate of

interest. "Innovations within credit unions and in financial markets generally have permitted their evolution as limited liability membership organisations operated democratically under a one-member-one-vote rule, usually financed entirely by members, with voluntary leadership, and having objectives consistent with those of cooperatives generally" (Pischke, 1991). The early *Rural Credit Union* and *Urban Credit Union* model provided microfinance services to the German farmers in the last century. Due to the assurance of financial credibility and motivating character, these models were followed rapidly throughout the Central Europe. Today, the World Council of Credit Unions includes more than 70 national associations, and more than 1500 credit unions in developing countries. Friedric W. Raiffeisen as mentioned earlier was the founder of Heddesdorf Credit Union in Heddesdorf, Prussia in 1864. He was considered to be the founder of *rural credit unions*; and Hermann Schulze-Delitzsch was the founder of *urban credit unions* in Prussia in the same period.

(b) Cooperative Model

Cooperatives provide microfinance in the form of credit to individuals and groups with limited resources. Savings are the strong bases of cooperatives to make them sustainable and capable to fulfil both the economic and social needs of their members and the communities where they are operating. In cooperatives, the money that is lent out, come from the members. So the members are not merely the clients but owners of the institution. Cooperatives are autonomous associations of persons united voluntarily to organise and operate any businesses in the society. These associations are governed by some established principles, i.e. open membership, democratic control, and equal contribution in the organisation.

The history of modern cooperative as a form of business enterprise dates back to 1844, when Rochdale Society of equitable pioneers, a consumer's cooperative, was established in England after the failure of a producer's cooperative formed in 1830 with the involvement of a group of 29 flannel weavers (Woelfel, 1994 pp. 438-440). Within a few years of formulation of this cooperative society, several other societies were expanded and legalised converting themselves into wholesale cooperative societies in England. The movement thus, initiated from England, was spread rapidly to Western Europe, USA, Canada, New Zealand and Australia in the early 19 century.

Actually, the cooperative model emerged out of a felt need to solve the problems posed by the agrarian economy of the then Europe and in the Asian countries mainly pre-independent India. At that time, small landholdings and fragmentation on the one side, and monopoly and usurious moneylenders on the other, were exposed as serious problem in the country. Sir Fredric Nicholson, in his report in 1897 had made a strong suggestion for the introduction of cooperative credit societies in India. Focusing mainly on agricultural credit, India developed largely the short-term (production credit) and long-term (e.g., land mortgage banks) cooperative credit structures. Primary Cooperatives Agricultural and Rural Development Banks (PCARDBs), or State Cooperative Agricultural and Rural Development Banks (SCARDBs) were established in the country. Consequently, towards

the end of 1997, there were 452,657 million cooperatives at all levels increasing the percentage of rural population covered by the agricultural credit cooperatives from 7.8 percent in 1951 to 36 percent in 1960/61; it further increased to 65 percent in 1985/86. Currently, 99.5 percent of the villages are totally covered by cooperatives (Puyalvannan, 1999).

(c) Association

In association type, the target community such as youth or women form an association regarding political, religious, or cultural issues through which, microfinance activities are initiated. In some countries, an "association" can be a legal body that has certain advantages such as collection of fees, insurance from the customers. Associations, the community-based organisations are also informal systems.

(d) Bank Guarantees

As the name itself suggests, a bank guarantee is used to obtain loan from a commercial bank. This guarantee may be arranged externally through donors/government agencies, and internally it is arranged using savings of its members. Bank guarantee is a form of capital guarantee scheme and the guaranteed funds can be used for various purposes including loan recovery. These days, many international and UN organisations have been creating international and guarantee funds that banks and NGOs can subscribe for/or start MF programmes.

(e) Self-help Group Model

Credit needs of the poor people, particularly of the rural poor, are characterised by the absence of any clear distinction between production and consumption purposes. Therefore, Self-help group (SHG) model evolved as an alternative mechanism for meeting both these needs. And the groups formed may be either existed spontaneously, or may be actively involved into voluntary agencies consisting of homogeneous members (10 to 12) belonging to poor sections of the rural society. Swiss Agency for Development and Cooperation considered this model as a viable alternative as well as a link between the formal financing system and the poor.

Historically, the SHG model is originated from the ROSCAs, which are effectively operated by different names in different countries. Particularly, Asia-Pacific Rural Agricultural Credit Association (APRACA) has encouraged this model since the early 1990s. This model was largely promoted in India in the form of savings and credit groups and non-credit groups. Non-credit groups include joint farming, social forestry program, rural industries, and marketing of farm and non-farm sector products. But the savings and credit groups are promoted for farm products. Several such groups in India are linked with National Bank for Agricultural and Rural Development (NABARD) in various development

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