



PlaNNet Finance

**How to Train on
Basic Credit and Business Appraisal Module**

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Learning Goal

Build & improve the capacity
of FMFB's staff on basic credit
& business appraisal

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Module Outline & Contents

Session 1: Principles, Concepts & Types of MF Lending

Session 2: Understanding the micro-business environment

Session 3: Simple business plan of Micro-entrepreneurs

Session 4: Basic Marketing Concepts

Session 5: Understanding Simple Financial Statements

Session 6: Credit Appraisal Process

Session 7: Collateral Analysis



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Session 1


Principles, Concepts and Types of Lending




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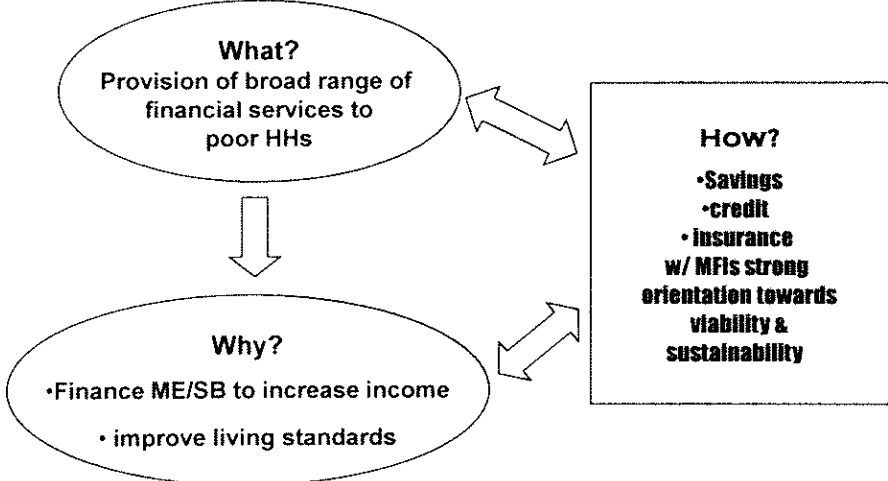
Paradigms on Credit


<p>Traditional</p> <ul style="list-style-type: none"> • Liability • Poor can't pay • Conventional collateral requirement • Bank as only source of formal credit • Subsidized credit is supply driven 		<p>Modern</p> <ul style="list-style-type: none"> • Asset • Poor are bankable • Collateral free/substitute • Banking at doorsteps • Demand driven
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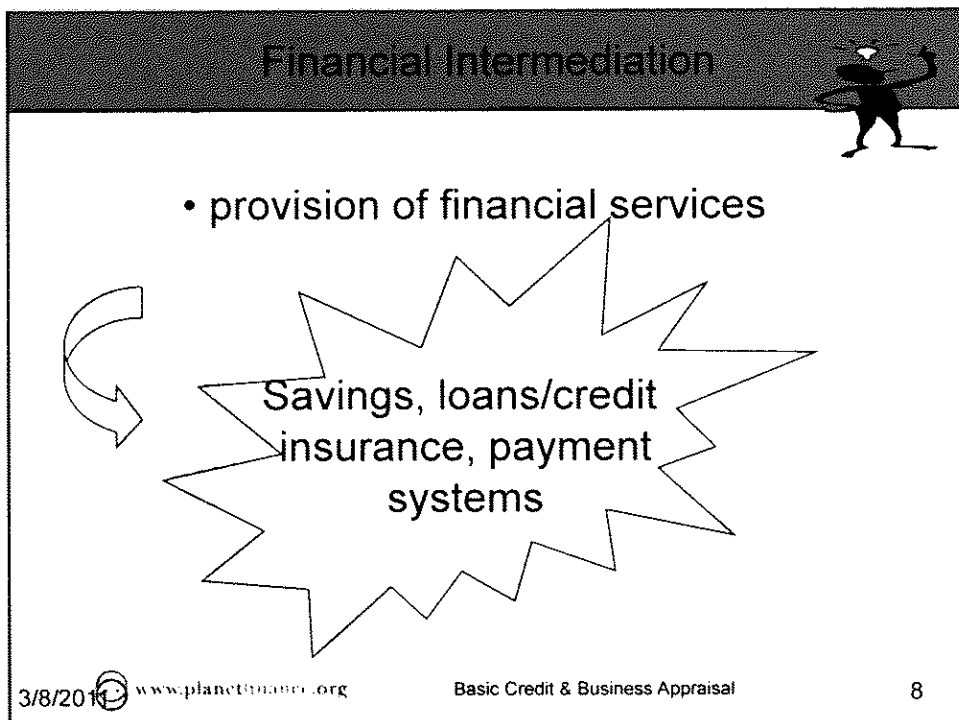
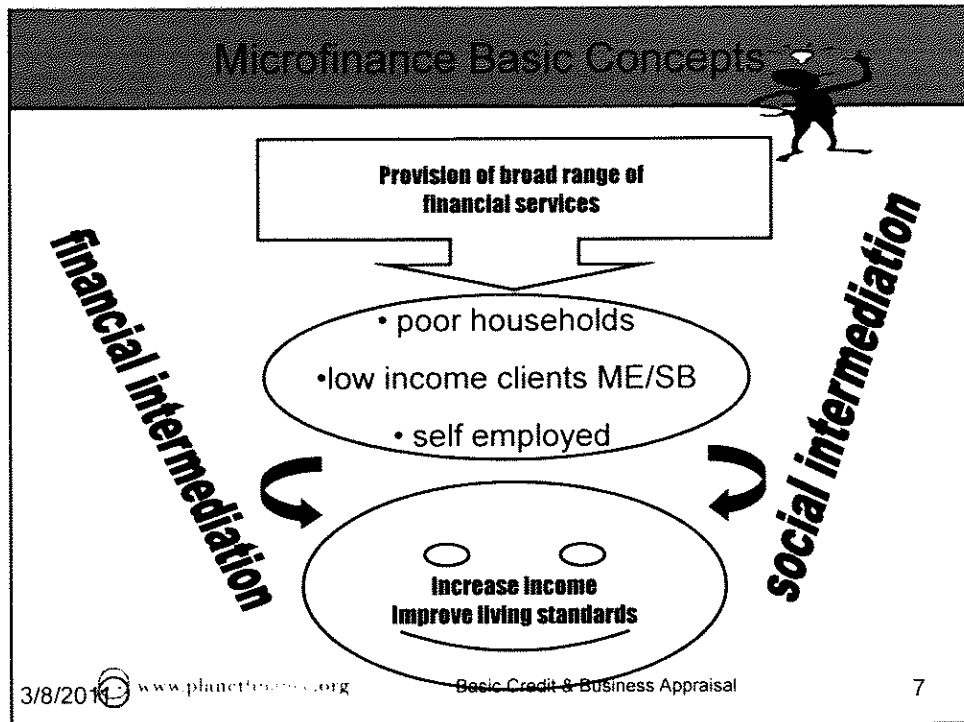
CREDIT AS HUMAN RIGHT!

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Microfinance Defined



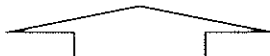
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Social Intermediation




**Process of building social and human capital
(social preparation, training/
capacity building, etc.)**




**Required for sustainable financial
intermediation for the poor**

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Enterprise Development Services




Non-financial services that assist micro-
entrepreneurs
*(business training, mktg./
technology services, skills dev't. etc.)*

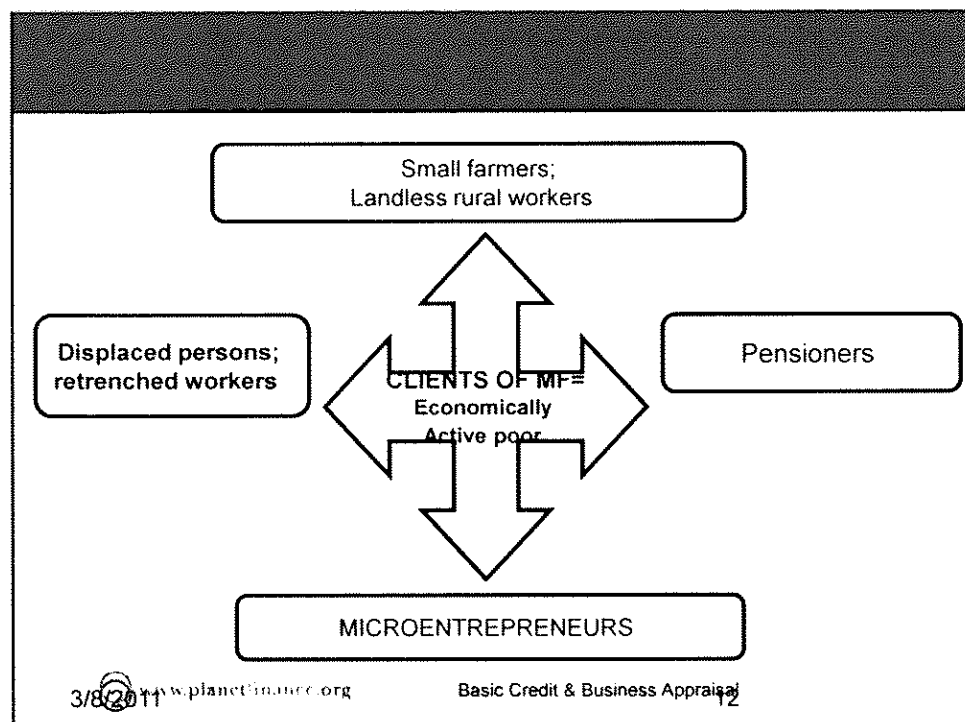
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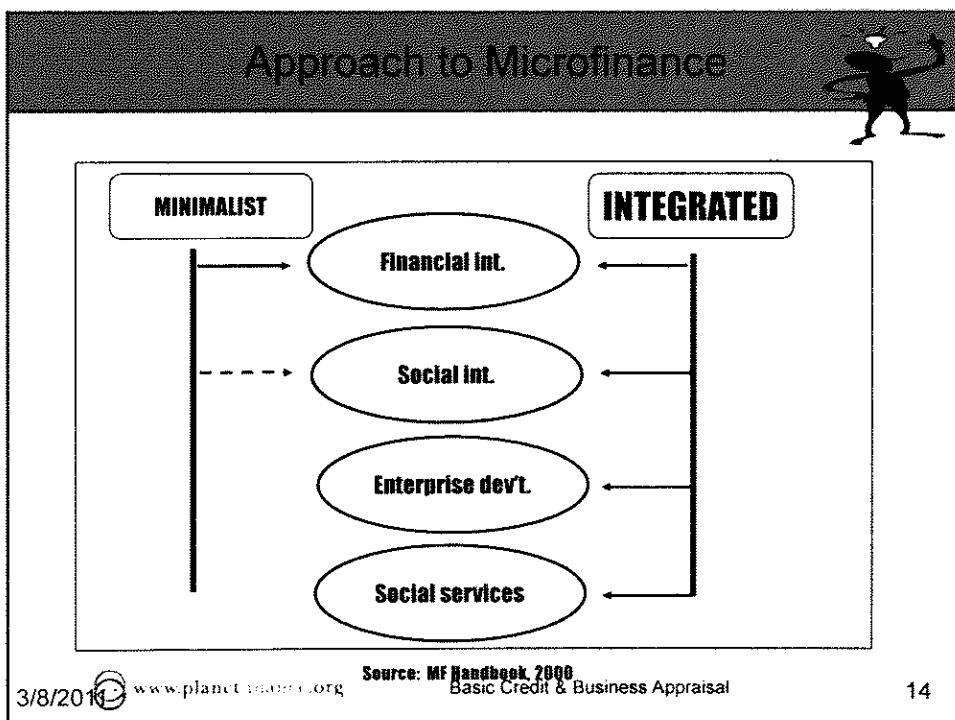
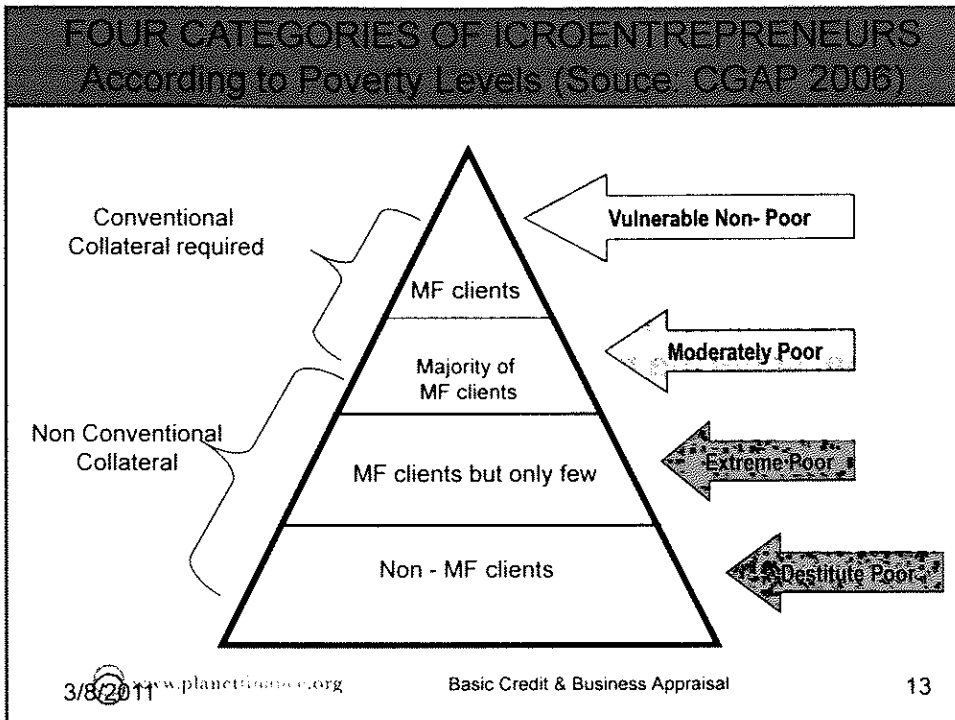
Social Services



**Non-financial services that focus on the well-being
of micro-entrepreneurs**
(health, nutrition, education, literacy training)

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Key Principles of Microfinance

- Poor people need a variety of Financial services, not just loans
- Microfinance is a powerful tool to fight poverty
- Microfinance means building financial systems that serve the poor
- Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people

Key Principles of Microfinance

- Microfinance is about building permanent & sustainable local financial institutions
- Microfinance is not always the answer & the best tool for everyone or every situation.
- Interest ceilings hurt poor people by making it harder for them to get credit

Key Principles of Microfinance

- The job of Government is to provide enabling policy & regulatory environment for financial services, not to provide them directly
- Donor funds should complement private capital, not compete with it
- The key challenge is the shortage of strong institutions and managers
- Microfinance works best when it measures and discloses its performance

THE 5 Cs CONCEPT

The 5 Cs concept offer you guidelines of assessing loan application and enables you to get deeper insight of the client's business and intended venture:

- CHARACTER
- CAPACITY
- CAPITAL
- CONDITIONS
- COLLATERAL

Basic Concepts of Lending in Microfinance

- **Canons of Good Lending**
- Must be in accordance with the MFI's policy, practice and principles
- Must satisfy clients' needs, contain realistic repayment arrangements which will be possible under all circumstances
- Must be after all due consideration of the borrower



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Basic Concepts of Lending in Microfinance

- **Applying the Good Canons (1)**
- No MFI should lend or not to lend depends entirely on the lender's decision to accept a certain level of risk. Depending on "The Risk of Acceptance Criteria".
- Reward in Lending does not come from the amount of risk taken but from the prudence with which risk is taken.



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Basic Concepts of Lending in Microfinance

Applying the Good Canons

- Clear understanding between lender and borrower
- NB: Never rush into making lending decisions and beware “Good Deals” declined elsewhere
- No personal Interest on the part of the MF Officer
- Complete & well documented loan



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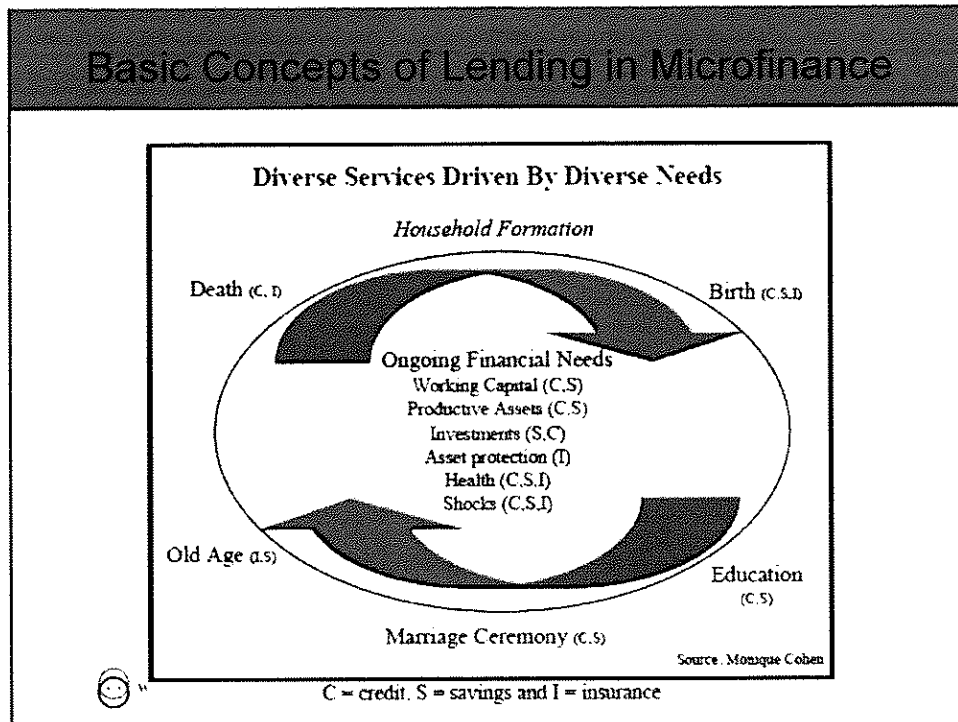
Basic Concepts of Lending in Microfinance


- The risk involved in an loan is obviously influenced by the purpose for which it is required, and the lender must be satisfied that the venture will succeed.
- Loan must be utilized for the stated purpose stated in the application.



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- ### 5 C's of Credit Assessment
- CHARACTER
 - CAPACITY
 - CAPITAL
 - CONDITIONS
 - COLLATERAL
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CHARACTER

The client's:

- Past borrowings
- Position in society
- Educational background
- Age
- Marital status
- Gender
- Experience



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CAPACITY

The client's past performance on:

- Profit trends
- Sales trends
- Asset base
- Products/ market share



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CAPITAL


- Initial capital
- Additional capital
- Amount borrowed or to be borrowed
- Sources of capital and terms

COLLATERAL

- Type of asset
- Marketability of the asset
- Value
- Stability of value


CONDITIONS

- Internal and external conditions
- Type of business
- Line of business
- Industry sector

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Types of Lending in Microfinance


- Asset Based Lending
- Project Based Lending
- Cash Flow Lending

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Types of Lending in Microfinance

Asset Based Lending Lending


- Loan is granted based on the value of the property offered as collateral/ security
- Determining income as source of repayment is of secondary importance
- Timing of payments are based on agreed period, rather than the period of cash inflow. Ex. Pawnshop lending, REM-secured loans

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Types of Lending in Microfinance

Pros / Cons of Asset-based Lending


Advantages	Disadvantages
<ul style="list-style-type: none"> ★ Lending appears less risky ★ Loan based on value of property; easy to determine 	<ul style="list-style-type: none"> ★ Greater risk of delinquency due to: <ul style="list-style-type: none"> - Loan size not based on borrower's repayment capacity - Repayment schedule not based of client's cash flow - Value of property could fluctuate

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Types of Lending in Microfinance

Project-based Lending


- A method of cash flow lending, which is based on the *future* or expected cash flows of the project or activity to be financed
- Collateral is of secondary consideration; primary consideration is the viability of the project


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Types of Lending in Microfinance

Pros / Cons of Project-based Lending

Advantages	Disadvantages
<ul style="list-style-type: none"> * Repayment based on cash flow of the project * Start-up projects may qualify; poorest households can have access. * Best suited for development or poverty-oriented credit programs 	<ul style="list-style-type: none"> * Highly prone to diversion of loan proceeds by borrower * Highly vulnerable to various project risks * Requires extensive analysis on feasibility/viability of the project



Enhanced by Lu de Castro

Types of Lending in Microfinance

Cash flow-based Lending

- Based on the borrower's *present* cash flows
- Loan amount is based on the capacity of the borrower to repay
- Repayment schedule is based on the borrower's timing of cash flows
- Collateral is not the primary consideration


Ex. Microenterprise loans, salary loans, business loans

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Types of Lending in Microfinance

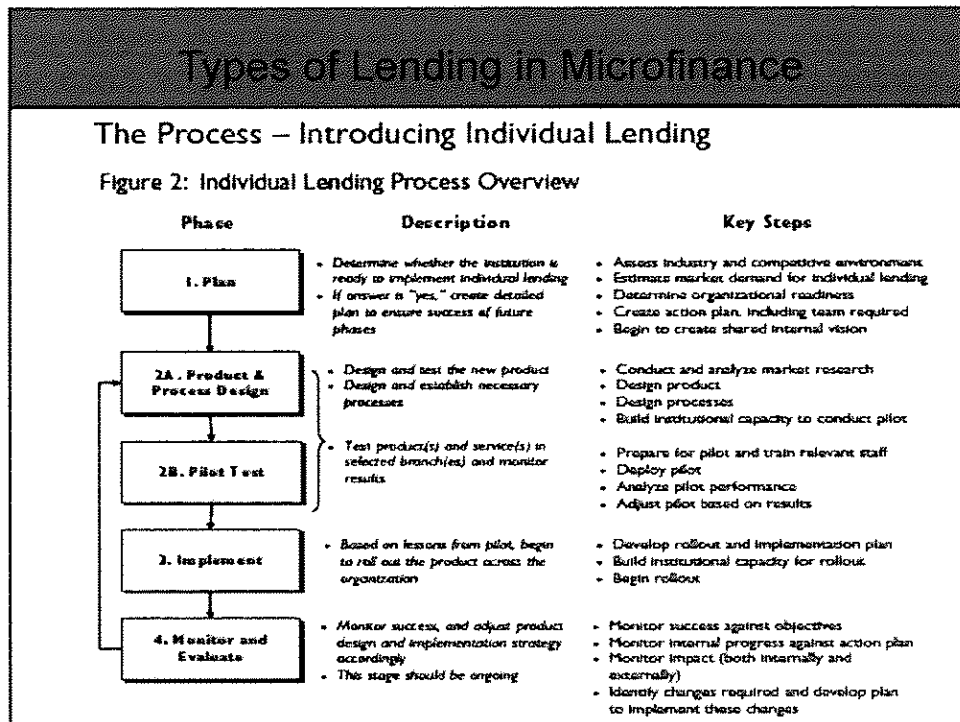
**Pros / Cons of
Cash Flow-based Lending**

Advantages	Disadvantages
<ul style="list-style-type: none"> * Default due to fund diversion minimized * Loan size, terms and repayment based on borrower's cash flow * Best suited for short-term, working capital loans 	<ul style="list-style-type: none"> * Conservative loan sizes * Initially, could work against low-income clients * Not the best tool for determining loan requirement of projects needing capital expenditures or long-term investment



Types of Lending Methodology		
Group Lending vs Individual Lending		
Point of comparison	Group Lending	Individual Lending
Collateral	Group guarantee	Collateral or guarantor/co-signer
Client selection	Group selects the members	Based on client reputation and/or repayment history
Loan analysis	Simple and done by the group	Detailed business analysis
Loan size	Short-term stepped loans	Depends on business needs and repayment capacity
Loan officer relationship	Not close; loan officer covers up to 600 clients	Close relationship; loan officer has fewer clients (2-300)
Loan officer time management	Less time following up on clients because it is the group's responsibility	More time required for following up clients
Cost	More cost to the MFI due to smaller loan sizes and shorter terms	Lower cost due to larger loan sizes and longer loan terms


Types of Lending in Microfinance	
Product definition for individual loans	
<ul style="list-style-type: none"> ▪ Target the enterprise/personal/housing needs of the poor ▪ Extend relatively small amounts based on estimated repayment capacity ▪ Short repayment period ▪ Based on creditworthiness rather than collateral ▪ Individual lending method ▪ Priced to ensure the long-term viability of the MFI ▪ Incorporates systematic due diligence and follow-up procedures 	
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Types of Lending in Microfinance

Key points to remember


- Ensure your organization possesses the right preconditions.
- You must understand your target client,
- You must create a sound team,
- You should seek external help,
- Your team, and senior management, must plan carefully,
- You should introduce individual lending gradually,
- You should conduct at least one successful pilot, and
- You should monitor and evaluate on an ongoing basis.

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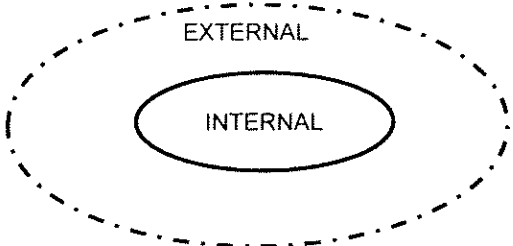
Session 2


Understanding the Micro-Business Environment

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Overview of Business Environment


There are 2 dimensions of environment:
Success or failure of a business depends on
how it responds to its environment.



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Overview of Business Environment

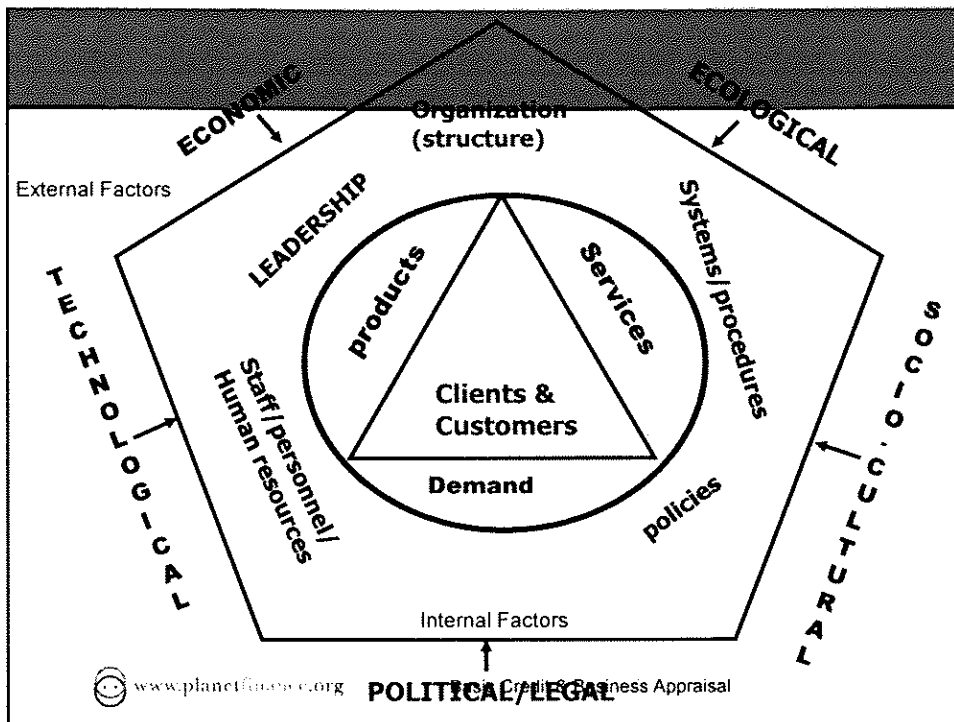
- Current business trend no longer looked at from an economic dimension only
- Focus on socio-political aspects e.g. employment policies, pollution control, safety & health, etc.

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Overview of Business Environment

- *External Factors:* Factors from outside that have an influence on the organization.
- *Internal Factors:* Factors from within the organization that have an influence on it.

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- ### Business Environment
- Political and legal
 - Economic
 - Socio-cultural
 - Technological
 - Ecological
 - Competition
 - Business ethics
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Political and Legal

- Business needs a social, physical and business environment. *All depend on political stability.*
- All business operate under formal rules and regulations *e.g. registration, tax laws*



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Economic Situation

- Economic growth
- Infrastructure
- Resources
- Money



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ECONOMIC SITUATION

These will cover issues like:

- Savings, debt and credit
- Income distribution
- Subsistence economy; presence of businesses
- Industrializing economy
- Industrial economy
- To what extent have these been achieved?

SOCIO-CULTURAL

Social

- Population growth
- Geographical distribution
- Ethnicity
- Wealth
- Family structures
- Employment

SOCIO - CULTURAL

Cultural

Beliefs, values and norms

- Marriage and family
- Lifestyle
- Eating and drinking habits

Knowledge of cultural environment helps
shaping the business

ADVANCES IN TECHNOLOGY

These will generally cover:

- Levels of Information and
Communication Technology.
- Research & Development budgets
in enterprises
- Regulations from government In
communication

ECOLOGY

- These will cover issues like:
- The physical and environmental surroundings.
- Pollution
- Source of materials
- Environmental conservation

COMPETITION

Review intensity of competition within sectors of the economy

- Which sectors have the highest competition
- What are the regulations on competition

BUSINESS ETHICS

- There is need to recognize and practice acceptable business ethics e.g.
- No child labour
- Corporate social responsibility
- Gifts or bribes, etc
- Production Practices

ENVIRONMENTAL SWOT ANALYSIS

SWOT is the acronym for:

- S-trength (Internal environment)
- W-eakness (Internal environment)
- O-pportunity (External environment)
- T-hreat (External environment)

It is a technique used to analyze the environment.

OPPORTUNITIES

- Favorable condition in the organization's environment, enabling it to consolidate and strengthen its position in the market; ex. Growing demand for the product/services
- Opportunities are classified according to their attractiveness and their success probabilities.



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THREAT

- unfavorable condition in the organization's environment, creating a risk for, or causes damage to the organization
- Threats are classified according to seriousness and probability of occurrence.



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STRENGTH

- an inherent capacity which an enterprise can use to gain a strategic advantage; ex. High client satisfaction



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WEAKNESS

- an inherent limitation or constraint which creates strategic disadvantages; ex. Dependence of one single service/product




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Session 3

Simple Business Plans for Micro-Enterprises

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What is a Business Plan?

A simple document which shows details
of how clients develop & manage their
micro-enterprises

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Components of a Business Plan

1. One page summary
2. Business & product description
3. Marketing plan
4. Management team & personnel
5. Financial forecasts

1. One Page Summary

Positioned at the front of the document; it should include highlights from each section incorporated in the business plan

2. Business & Product Description

- What is the nature of the business;
- location
- what the business sells
- the market you want to address
- what makes it different
- what benefits it offers
- why customers would buy it
- how you plan to develop your products or services
- the key features of your industry or sector



3. Marketing Plan

- Product
- Price
- Place
- Promotion



4. Management & Personnel

Explain who is involved in the business

- family members or hired workers
- part time or full time
- who is doing what in managing the business?

5. Financial Forecasts

- sources of revenue and income
- how much capital is needed
- source of funding (internal or external)
- how you plan to repay borrowings
- financial records



Simple Business Plans for Micro-Enterprises

Why is business plan training important?

- After business training, client retention increased by 5%, default rate decreased from 4% to 3%, there was a 10% improvement in correct responses made on a questionnaire about business principles, 4% increase in reinvestment of profits in the business, and a 16% increase in their business sales.
- This supports not only the clients' business but the profitability of the MFI as well.



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Session 4

Basic Marketing Concepts



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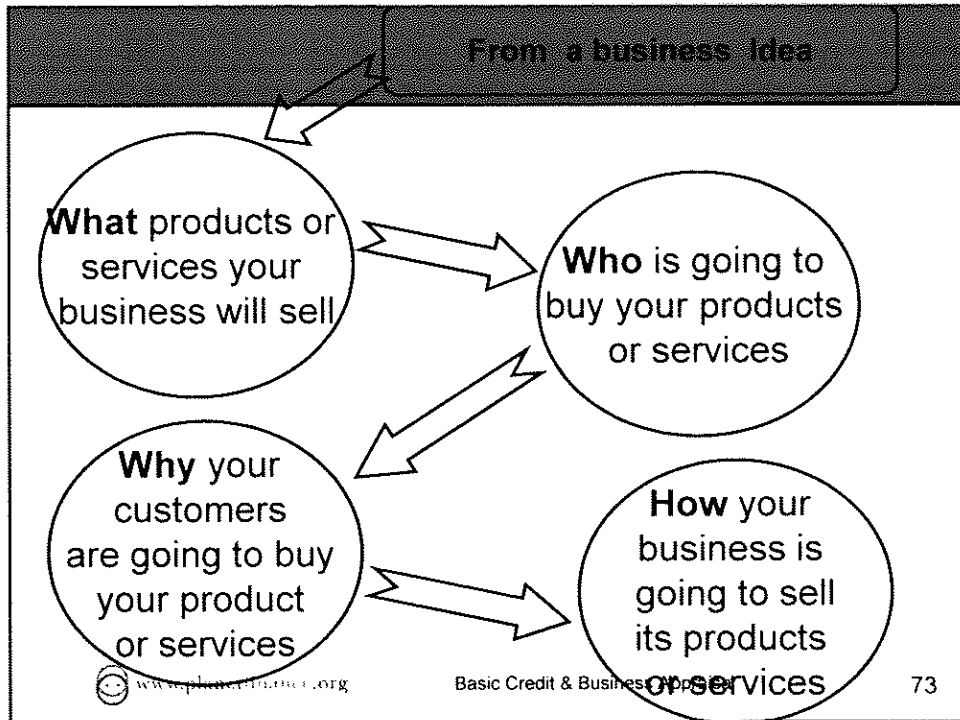
Why do people start businesses?

- To make profits, which come from sales which come from customers.
- More profits therefore means more sales and more customers.
- No customers, no sales, no profits



What is marketing?

- identifying customers needs,
- developing a product to meet those needs &
- constantly changing the product in line with changing needs of the customer



Importance of Marketing

- single most important component of a feasibility study
- determines the success of a business
- the lifeblood of a business

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Question

What is the difference between
marketing for a microenterprise
&
marketing for a MF institution
(like FMFB)?



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Answer

- No difference.
- Principles are the same.
- An MFI like any other business org'n,
 - ✓ should identify the needs of the customers it wants to serve,
 - ✓ develop products to meet those needs &
 - ✓ keep on improving those products to meet changing needs of the customer




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Remember!

**Without a
CUSTOMER/CLIENT
there is no business;
Without business,
ECONOMY is dead**

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Marketing Mix

- What is marketing mix?
 - ✓ Refers to the 4 core Ps in marketing
 - ✓ Lately, another 4 Ps are added

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Basic Marketing Concepts


MARKETING 8 Ps

1st "Ps"

- Product
- Price
- Promotion
- Place/distribution

2nd "Ps"

- Positioning
- Physical evidence
- Processes involved
- People

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Basic Marketing Concepts

PRODUCT



- ✓ anything that meets a customer's needs.
- ✓ most important connection is the customer's needs.
 - Range of product lines
 - Design of product – size, shape, color...
 - Packaging
 - Branding
 - After sales service


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Product

- Physical Product: Coca Cola, Pen, Book, loans
- Services: Hair cut, vehicle repair,
- People: MFO, managers, employees, workers
- Places: Hotel, park

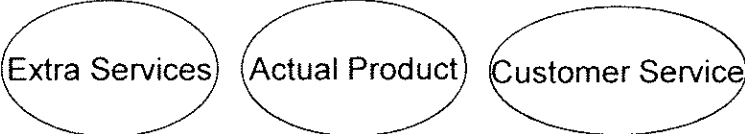
"In marketing all the above are products"





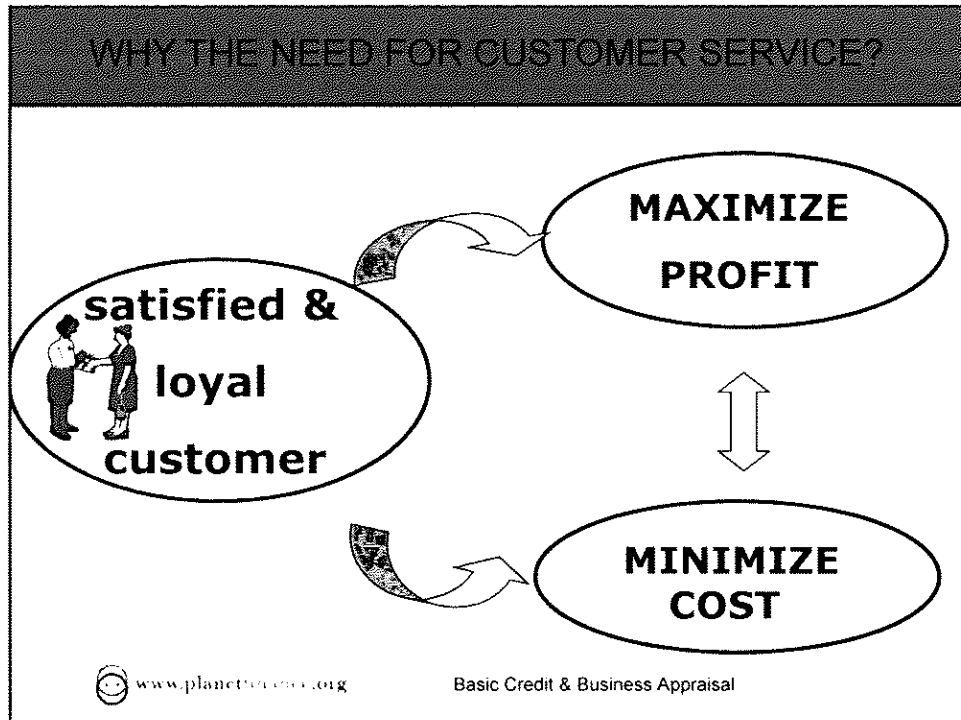
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Features of a product

- Customers will not just buy a product;
They are looking for something more



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Conclusion:

For a business to succeed,

- ✓ it must sell the right product based on the needs of the customers
- ✓ provide extra services & satisfactory customer service.

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Price

A value of a product or services to a customer

The customer makes judgments before buying. If they think the product is worth the same or more than the indicated price, they need it and they have the money, they will buy the product.

- Discounts – trade, quantity, etc
- Demand situation – peak, off season,...
- Profitability level desired
- Cost of production
- Competition



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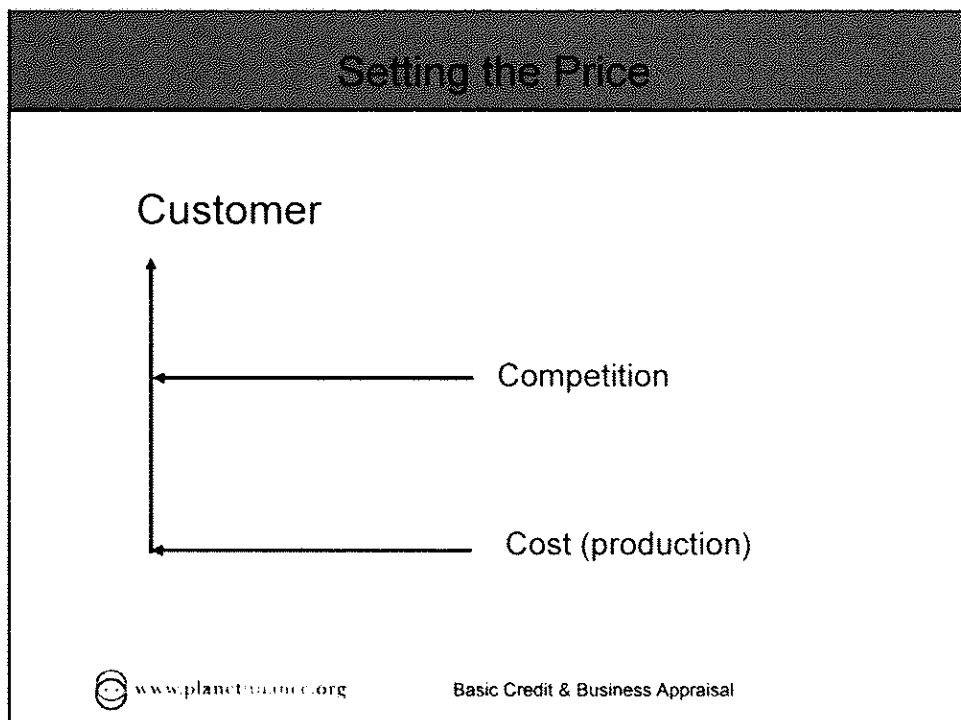
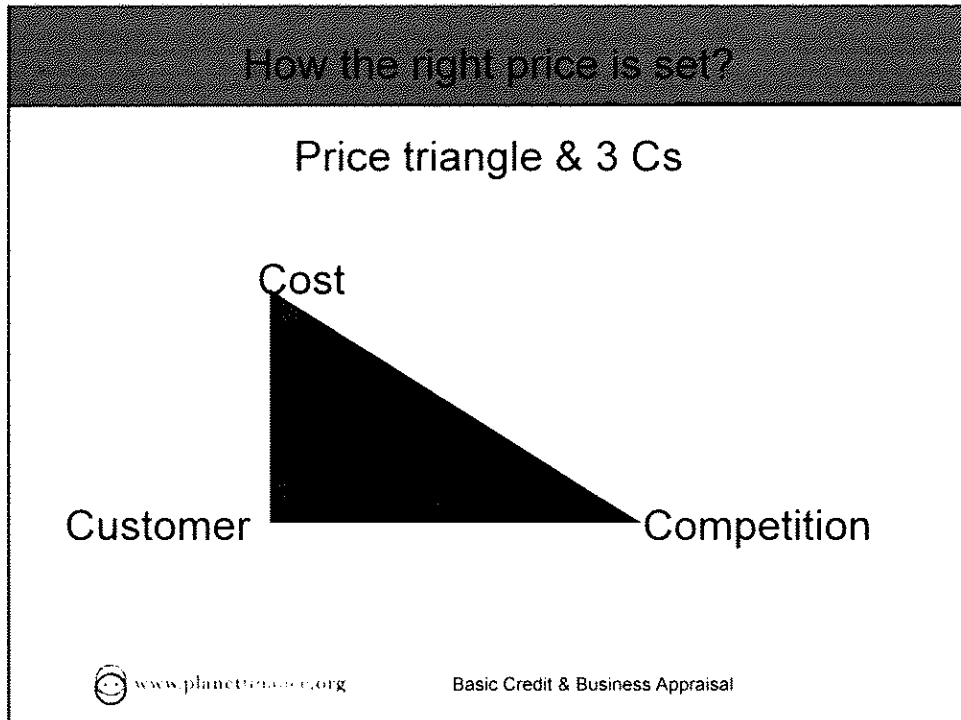
Other names for price

- Salary
- Commission
- Bribe
- Tax



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Setting the price

- ✓ Costs determine the lowest pricing level,
- ✓ Customers determine the highest level,
- ✓ Competition regulates the actual price level between these two (highest and lowest) levels



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Pricing Methods

- Fixed Prices
- Bargaining

What is the difference between the two?
Which one is better?




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Fixed Pricing Vs Bargaining

Neither of the two is better than the other. It depends.

<u>Fixed</u>	<u>Bargaining</u>
Easy to manage by workers money on a customer	Can make more rich
Saves time	Allows developing social relations
Allows price displays & advertising	Attracts curious enquiries from customers

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Fixed Pricing Vs Bargaining

- ✓ a business should choose one.
- ✓ fixing prices & then bargaining is the worst of the two worlds.

NEVER DO IT!

Why?

Customers will think you are a liar !!!


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Psychological Pricing

➤ attempt to influence customer thinking to make the price look lower & more favorable than it is in Reality.


~~500~~ 499.95 ~~1000~~ 999.95

➤ Used during seasonal stock clearance sales or during sales promotions.

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Promotion

- Advertising
- Sales promotion
- Publicity
- Direct selling

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Promotion

refers to communication to existing and potential customers about the business' products,

GOAL: persuasion to buy; thru offering different incentives such as price discounts, offers, etc.

Sales Promotion

a special offer aimed at increasing business sales.

Traditionally, there are three types of sales promotions:

Trial promotion

aimed at encouraging a customer to buy or try a product for the first time.

often used in two instances:

- ✓ to promote a new product or
- ✓ new business

Loading Promotion

encourages customers to buy more than usual.

By encouraging customers to buy more than they would normally do, the business increases its sales from the usual volume of customers

Loyalty Promotion

- encourages customers to come back again.
- it creates a bond of loyalty which ensures that customers remain loyal to the business



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Conditions of sales promotion

- To be effective, three main conditions must be met:
 - ✓ It should be conditional
 - ✓ Time limit
 - ✓ Should be advertised



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Advertising

- Advertising is a way of telling existing and potential customer about your business or products
- What are the different methods that a business uses to advertise?



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Methods of advertising

- TV, Internet, Sign Boards, Calendars, Radio, Brochures, Sales letters, Business Cards, Exhibitions, Sponsorship programs, message boards at the business premises, word of mouth, other customers, newspapers etc
- But small business should choose appropriate methods of advertising




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Place


- method through which products or services are made available to customers

- Another word for “*Place*” is distribution channel.
 - ✓ Use of distributors, wholesalers, etc
 - ✓ Use own transport
 - ✓ Appropriate location

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Place

*Think of a business &
how many different ways it can make
its
products available to customers.*

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Distribution channels

Business can make their products or wares available through:

- ✓ Selling directly from factory,
- ✓ having display shops in town,
- ✓ using wholesalers,
- ✓ market stalls,
- ✓ sales men and women etc



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Middle men/women

refers to distribution channels used by business to reach customers, an intermediary or agent.

by using them, a business reduces profits because somebody comes in between the business and the customer.

Why use intermediary then?



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Effects of intermediary

Individual Exercise:

A business produces mineral water at 0.2 per bottle, sells to a middle man/woman at 0.3 who sells to a customer at 0.5.

If the business sold 10 bottles directly to the customer, it makes a profit of $5-2=3$ but by selling through a middle man, the profit is $5-3=2$.



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Effects of intermediary

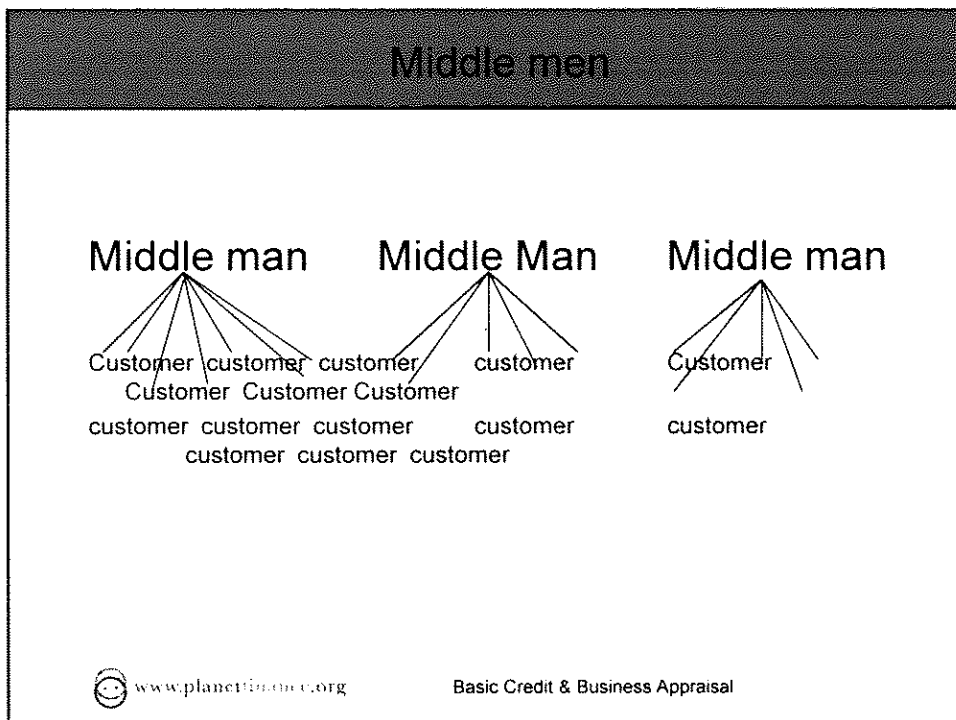
Individual Exercise:


Which is better then, to use a middle man/woman or to sell directly to customer?



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- ### Use of middle men
- Middle men are specialized sellers, manufacturers are not
 - By using middle men, manufacturers have the possibility to sell through many outlets which would be too costly to set up.
 - The use of middle men exposes the products of the manufacturer to the many customers of these middle men
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Total profits?

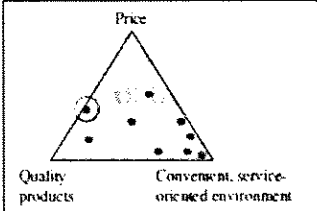
- In our example of profits using middle men, we saw that a manufacturer makes 2 euro per 10 bottles while he would make 3 euro if he sold directly to the customer.
- Because he will obviously sell more using the middle man, let us assume that he can sell 25,000 bottles through middle men but only 10,500 if he sold directly to customers.
- Calculate the profit he would make in both scenarios.

Conclusion


For a business to succeed,
it should sell
its products in the right place or
distribution channels.

Positioning

Your value proposition is why your customers will want to do business with you.




Product attribute	Brand	Customer Relationships
<ul style="list-style-type: none">• Functionality• Quality• Price• Time• Uniqueness	<ul style="list-style-type: none">• Brand equity	<ul style="list-style-type: none">• Comfort• Convenience• Trust• Flexibility

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Physical Evidence

- Includes the presentation of the product;
- how the business site physically looks: whether it is tidy or dirty, paint new or decaying,
- The appearance of brochures, passbooks, etc

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Processes Involved

- Includes the way or system in which or through the product is delivered
- How the transaction is processed and documented
- The queues / waiting involved
- How forms are designed, etc



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People

- Includes how clients or customers are treated
- Employees or hired workers
- Recruitment, internal communications, performance monitoring and training



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Marketing Strategies for any business

- **Marketing Mix strategies**

The marketing mix combines several integral elements to achieve recognition in the market place;

- A greater market share
- A strong competitive position and
- A positive image with customer.

The goal of any marketing mix should be to increase **customer flow, sales and profits.**



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Summary

For a business to succeed, it should sell the

- **RIGHT PRODUCT**, at the
- **RIGHT PRICE**, in the
- **RIGHT PLACE** and with the
- **RIGHT PROMOTION.**




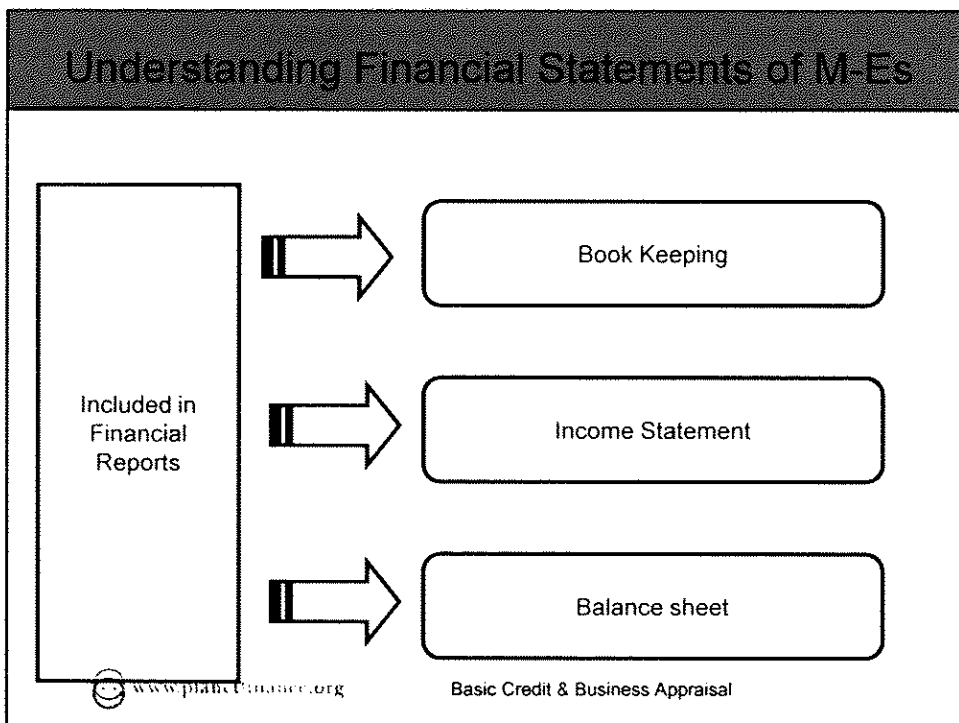
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Session 5

**Understanding Simple Financial
Statements of
Micro-enterprises**


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Understanding Financial Statements of M-Es

BOOK KEEPING


- date of buying or selling,
- number of invoice,
- items bought or sold,
- quantity,
- price

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Understanding Financial Statements of M-Es

Buying Book

No.	Date	No of invo.	Items	Quantity	Price	Value
1	01.10.2005	125	Pepper	500 Kg	0.5	250 €
2	01.10.2005	126	Potato	250 Kg	0.2	50 €
3	01.10.2005	127	Tomato	125 Kg	0.8	100 €
	Daily Amount					400 €
4	02.10.2005	//	//	//		// €
	Daily Amount					€
5	04.10.2005	129	Cucumber	50 Kg	1.0	50 €
6	04.10.2005	130	Watermelon	300 Kg	0.2	60 €
	Daily Amount					110 €
7	05.10.2005	131	Carrots	50 Kg	0.3	15 €
8	05.10.2005	132	Grapes	150 Kg	1.0	150 €
	Daily Amount					165 €
11	MONTHLY AMOUNT					€

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Understanding Financial Statements of M-Es

Selling Book

No.	Date	No. of Invoice	Items	Quantity	Price for Kg	Value
1	01.10.2005	125	Pepper	200 Kg	0.8	160 €
2	01.10.2005	126	Potato	50 Kg	0.5	25 €
3	01.10.2005	127	Tomato	25 Kg	1	25 €
	Daily Amount					210 €
4	02.10.2005	128	Pepper	100 Kg	0.8	80 €
	Daily Amount					80 €
5	04.10.2005	129	Cucumber	3 Kg	1.2	3.60 €
6	04.10.2005	130	Watermelon	15 Kg	0.3	4.50 €
	Daily Amount					8.10 €
7	05.10.2005	131	Carrot	2 Kg	0.5	1 €
8	05.10.2005	132	Grapes	10 Kg	1.2	12 €
	Daily Amount					13 €

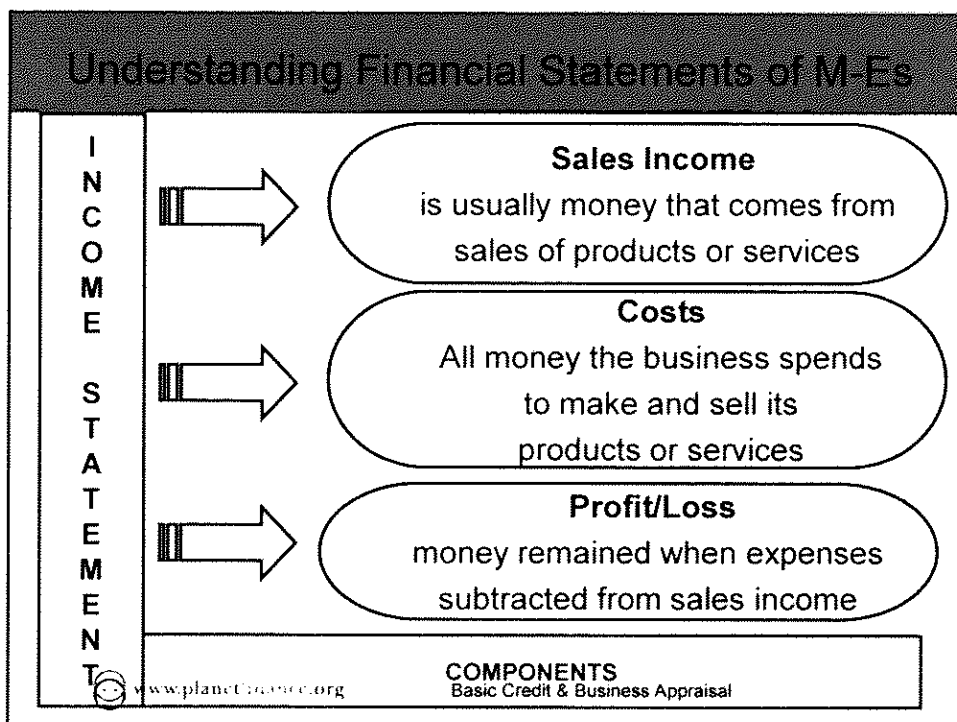
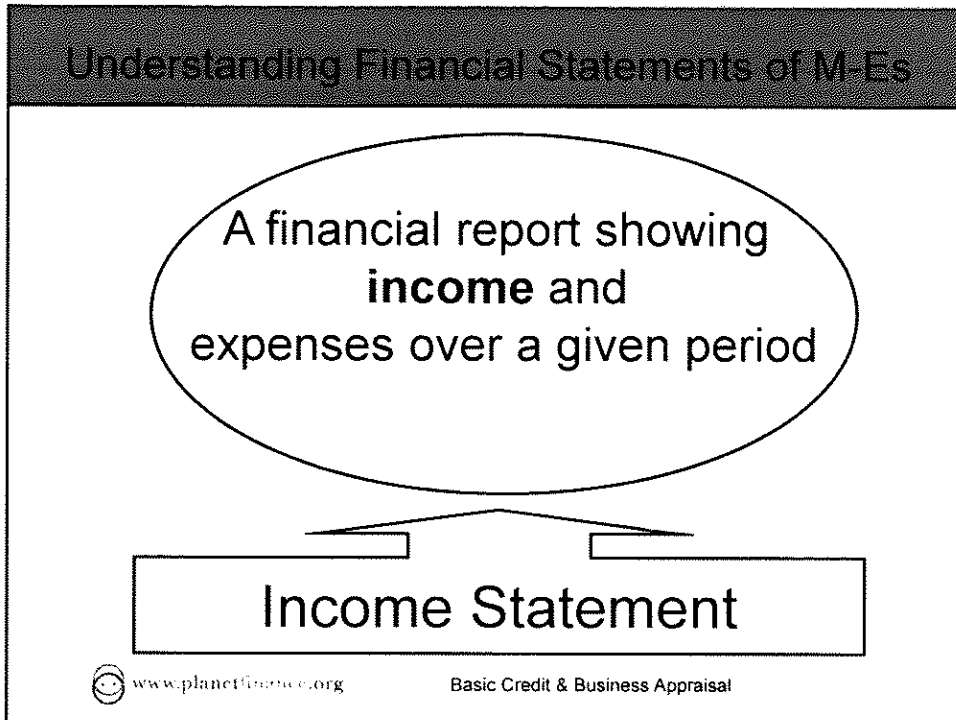
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Understanding Financial Statements of M-Es

Comparison of Bookkeeping

	Amount	Months	Total
SELL	1000	12	12,000
BUY	800	12	9,600
GROSS PROFIT	200	12	2,400

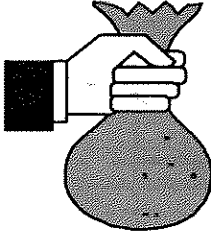
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Understanding Financial Statements of M-Es

Gross Profit

Gross profit is the profit remained when cost of goods sold subtracted from sales income

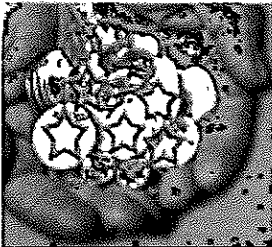

$$\begin{array}{r} \text{Sales income} \\ - \text{Total costs} \\ \hline = \text{Gross profit} \\ \text{(before tax)} \end{array}$$


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Understanding Financial Statements of M-Es

Net Profit

Net profit is the profit remains when other expenses (taxes, rent, salaries etc...) subtracted from Gross Profit



$$\begin{array}{r} \text{Gross profit} \\ - \text{Other expenses} \\ \hline = \text{Net profit} \end{array}$$

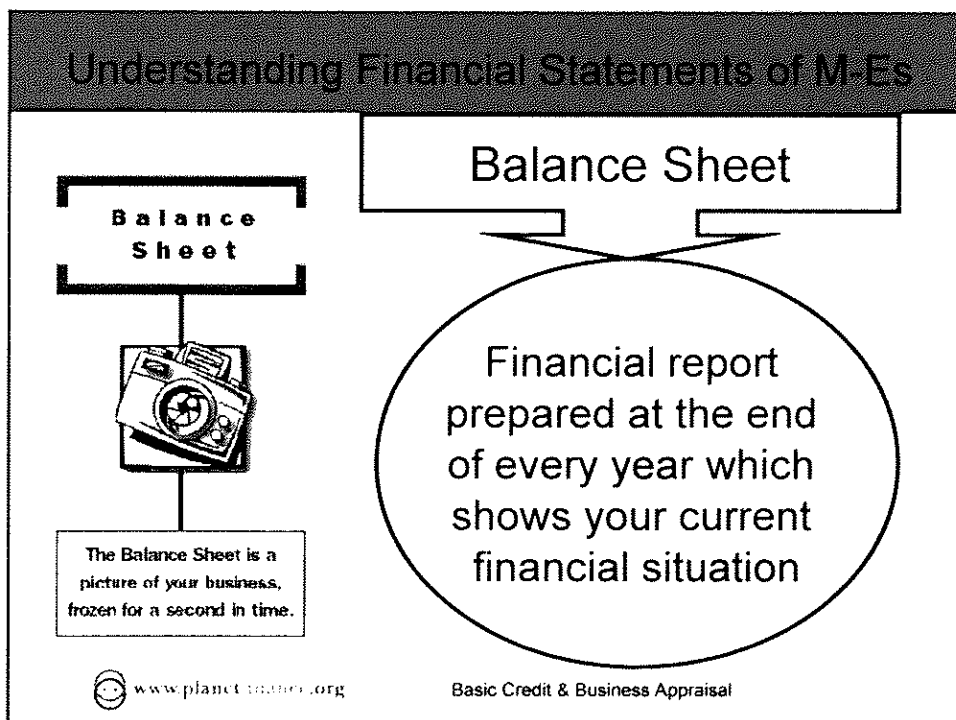
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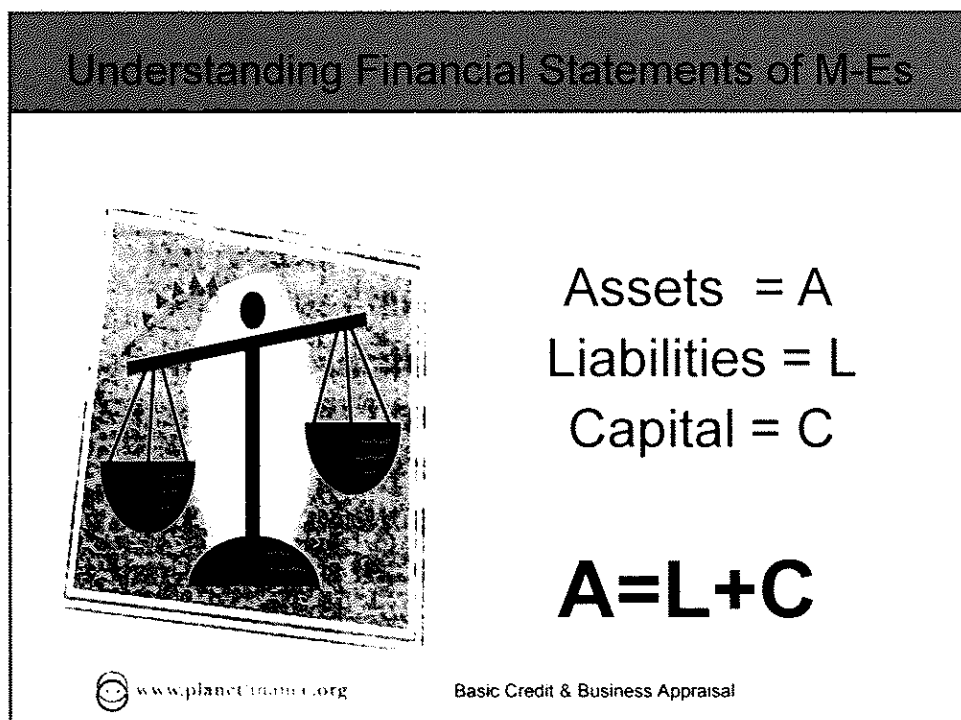
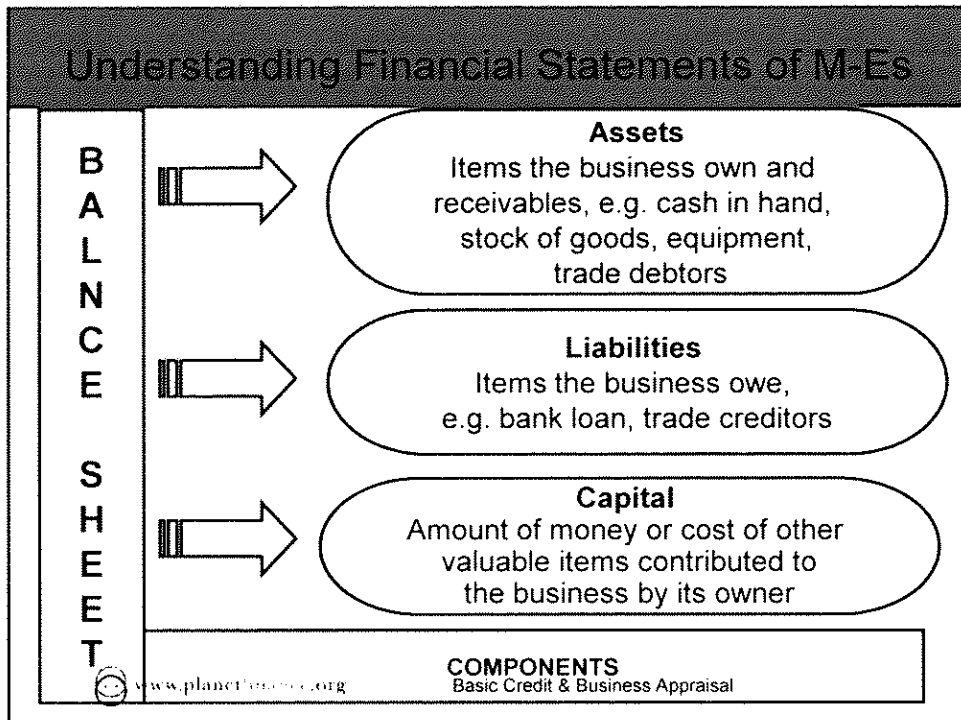
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Income Statement

Income statement	EURO
Sales	1000
Cost of goods sold	800
Gross profit	<u>200</u>
Labor cost	30
Utilities	10
Interest	10
Tax charge	30
Total Expenses	<u>80</u>
Net Profit	<u>120</u>

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Understanding Financial Statements of M-Es

Balance Sheet


No	Assets	Value	No	Liabilities and Capital	Value
1	Money in cash	1 000 €	1	Payable Account	1 000 €
2	Bank Deposits	200 €	2	Different Accounts	250 €
3	Receivable Account	500 €	3	Borrowing from the others	500 €
4	Work Tools	500 €	4		
5	Vehicle	1 500 €	5	TOTAL LIABILITIES	1 750 €
6	Material	8 000 €	6		
7	Buildings	10 000 €	7	Starting Capital	10 000 €
8			8	Profit	9 950 €
9			9		
10			10	TOTAL CAPITAL	19 950 €
17	TOTAL ASSETS	21 700 €		TOTAL LIABILITY AND CAPITAL	21 700 €

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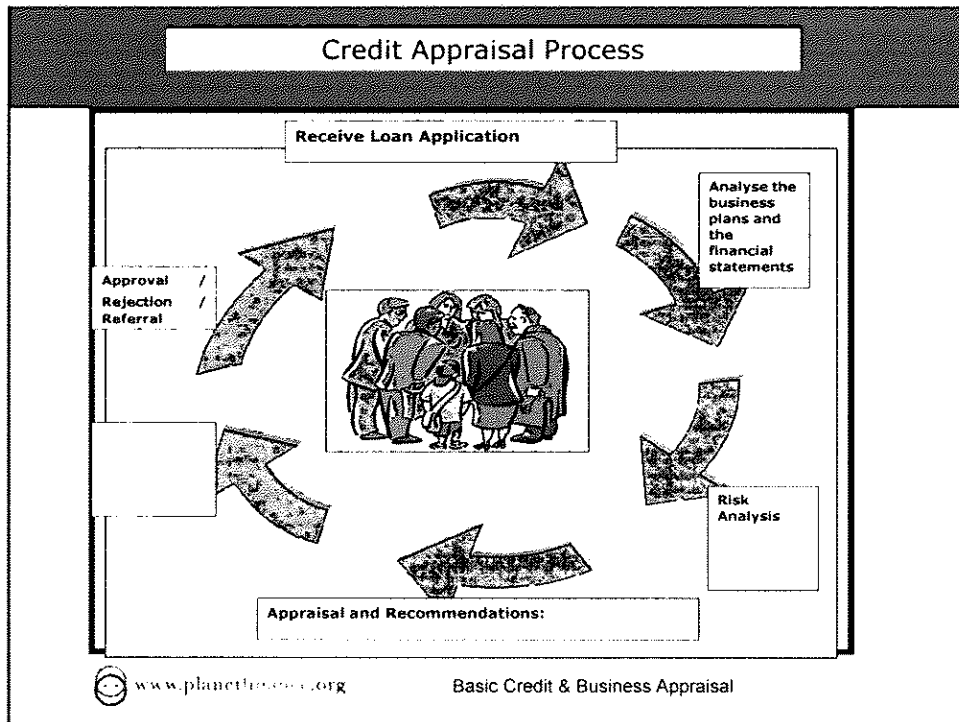
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Session 6

**The Credit Appraisal
Process**

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Conducting Effective Credit Appraisal

The credit committees are charged with the following responsibilities:

- Make loan decision
- Rule of loan application
- Make sure loan lending policies are enforced
- Gives recommendation for new product development

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Conducting Effective Credit Appraisal

- Process of appraising the credit worth of an individual.
- Process of making a decision after identifying and weighing the risks.
- Identifying risks, risk management and managing liability before issuing a loan.



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Conducting Effective Credit Appraisal

The 8 C's of credit is one tool that the loan officer can use in loan appraisal. The 8 C's of credit refer to;

1. Character
2. Capacity
3. Capital
4. Cash flow
5. Collateral
6. Conditions
7. Commitment
8. Current asset ratio



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1. Character

On Character the person charged with the responsibility of loan appraisal should ask the following questions :

- Is the client borrowing for good reasons?
- Is the client taking advantage of the lender?
- Can a client honour an obligation to pay a loan?

2. Capacity

Capacity

The credit officer should have answers for the following questions:

- Is the client portraying an ability to pay the loan?
- What is the client past business performance?
- How much money can the business accommodate?

3. Capital

Capital

The credit officer should have answers for the following questions:

- What is the current financial position of the client?
- What is the net worth of the client's business?
- What is the debt vis-à-vis capital asset of the client's business?



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4. Cash flow

The credit officer should have answers for the following questions:

- What are the client's Cash flow projections?
- Does the cash flow projection justify the loan requirement?
- Is the client servicing other loans?



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5. Collateral

The credit officer should have answers to the following questions?

- Is the collateral offered by the client a good value for the loan?
- How fast is the collateral offered convertible into cash?
- Is the collateral free from encumbrances?
- Are there any conditions attached to collateral?

6. Conditions

The credit officer should have answers for the following questions:

- What is the current economic trend?
- What is the current business environment?

7. Commitment

The credit officer should have answers for the following questions?

- Is the client borrowing from multiple sources?
- What is the size of debtors compared to creditors?
- Is the client able to pay back the loan and interest based on details provided?



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8. Current Asset Ratio

The credit officer should have answers for the following questions?

- Is the client borrowing from multiple sources?



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Commonly Used Ratios in Credit Appraisal

Cash Flow Analysis:

Monthly Loan Payment _____
 $\leq 8\%$
Monthly Sales

recommendation: to have a monthly payment of no more than 8% of actual sales, with a maximum of 10% for selected microbusinesses.

Commonly Used Ratios in Credit Appraisal

Working Capital Increase ratio:

- minimize the risk of client losing the business's working capital due to lack of experience managing a large quantity of money.

Working Capital Increase

Formula:

$\frac{\text{Working Capital AFTER loan}}{\text{Working Capital BEFORE loan}} < 2$

Commonly Used Ratios in Credit Appraisal

- Recommendation: the amount of the loan to be used for working capital should not exceed the amount of working capital that the client is currently managing (resulting in a maximum index of 2.0).
- *For example, if the client has US\$500 of working capital, the loan should not contain more than US\$500 of additional working capital (US\$1,000/US\$500 = 2.0).*

Commonly Used Ratios in Credit Appraisal

Repayment Capacity Ratio:

$$\frac{\text{Monthly Loan Payment}}{\text{Monthly Sales}} \leq 8\%$$

recommendation: to have a monthly payment of no more than 8% of actual sales, with a maximum of 10% for selected microbusinesses.

Risk Identification

Some common risks that you may face in MFI operations include:

- Credit risk
- Fraud risk
- Interest rate risk
- Currency risk
- Human resources risk (quality staff leave)
- Regulatory risk

Credit Risk

DEFINITION OF CREDIT RISK

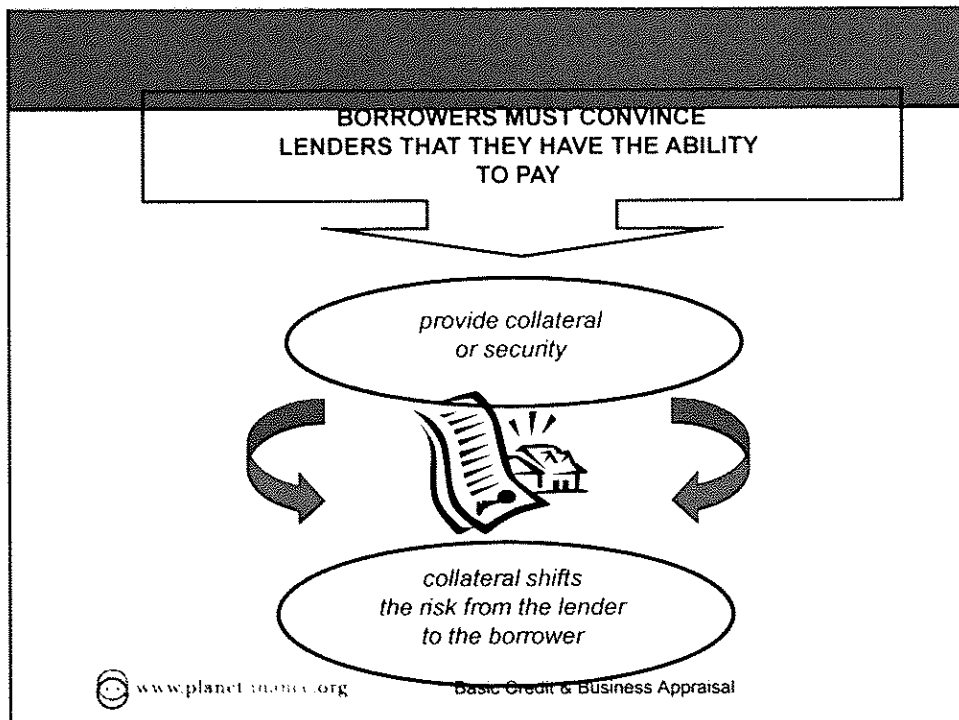
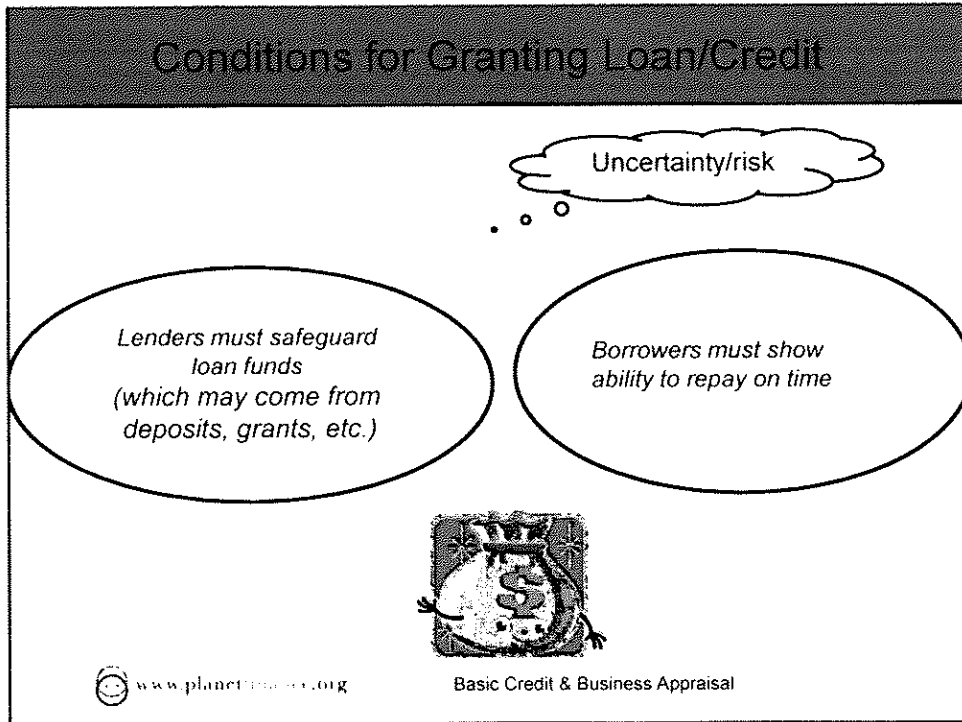
Credit risk is a financial industry term meaning the level of risk or likelihood of future default by an individual borrower.

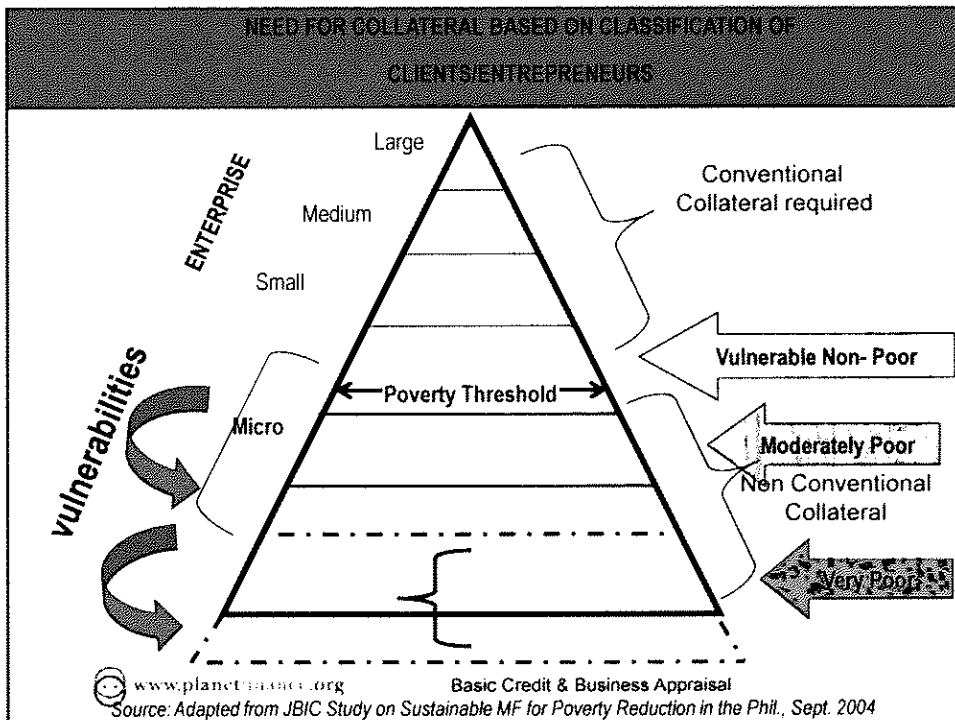
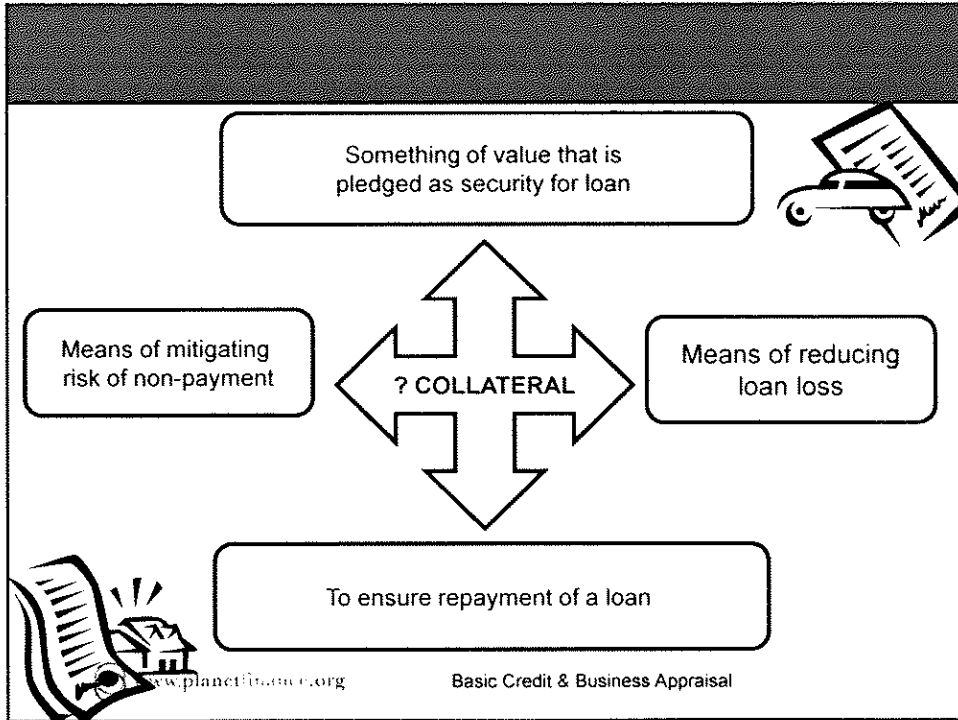
Factors in Credit Risk Evaluation

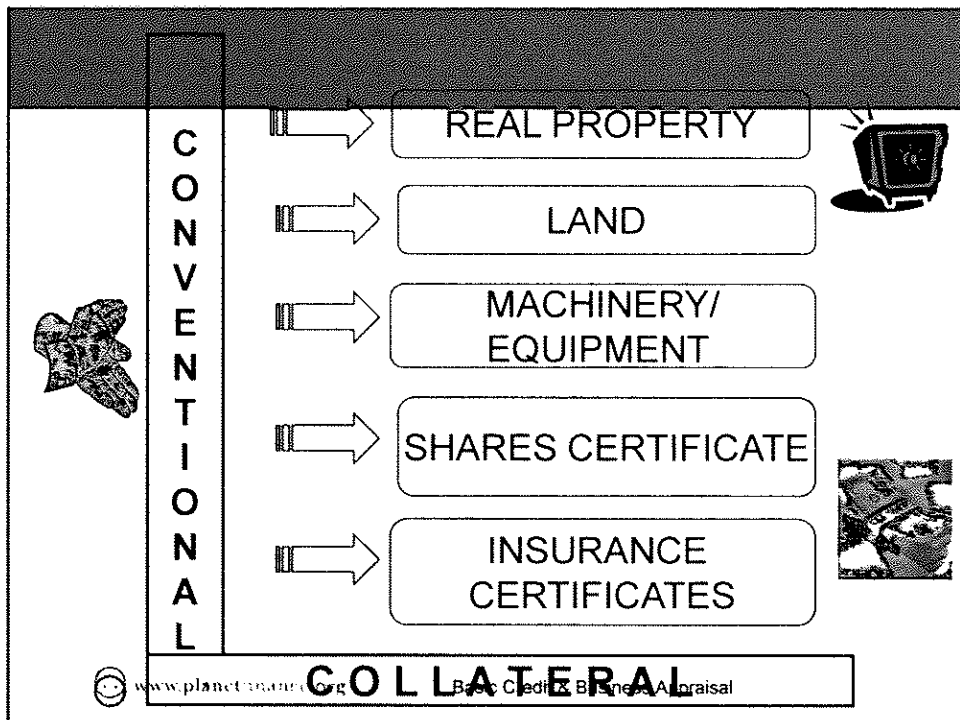
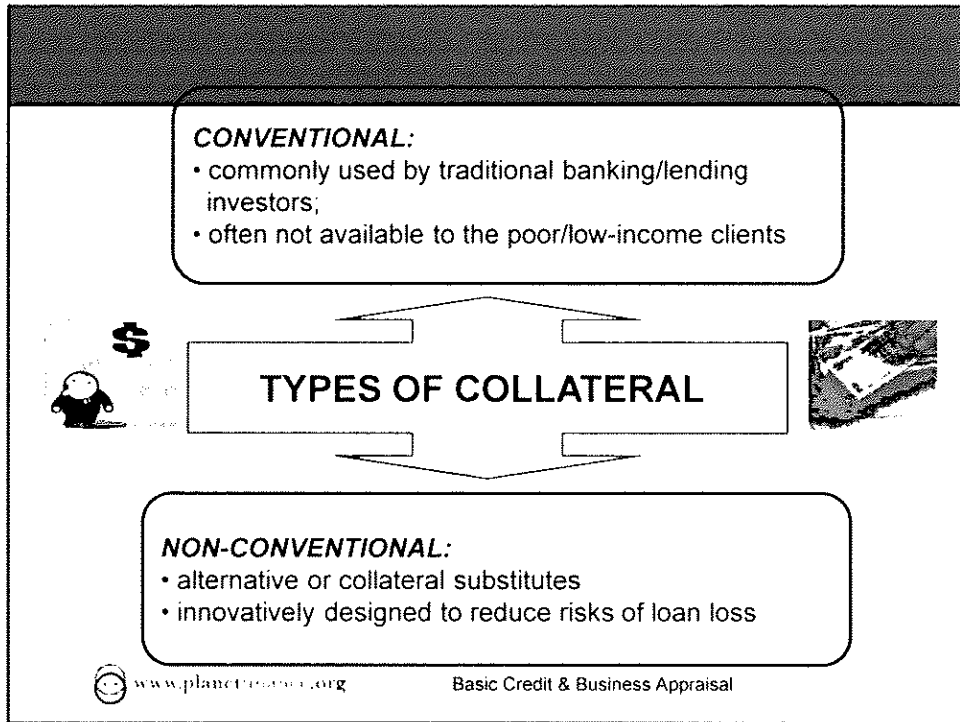
- History of non payment
- Public record information
- Number of competitors In a business
- Non marketability of products
- Liquidity of an existing business
- Evidence of collection accounts
- Recent delinquent accounts

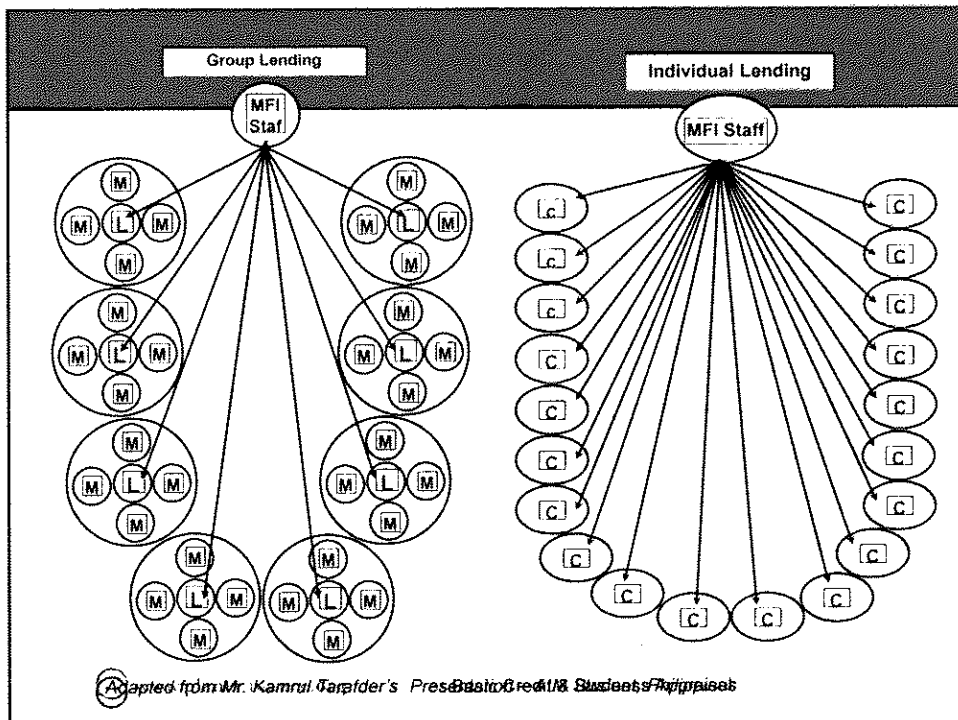
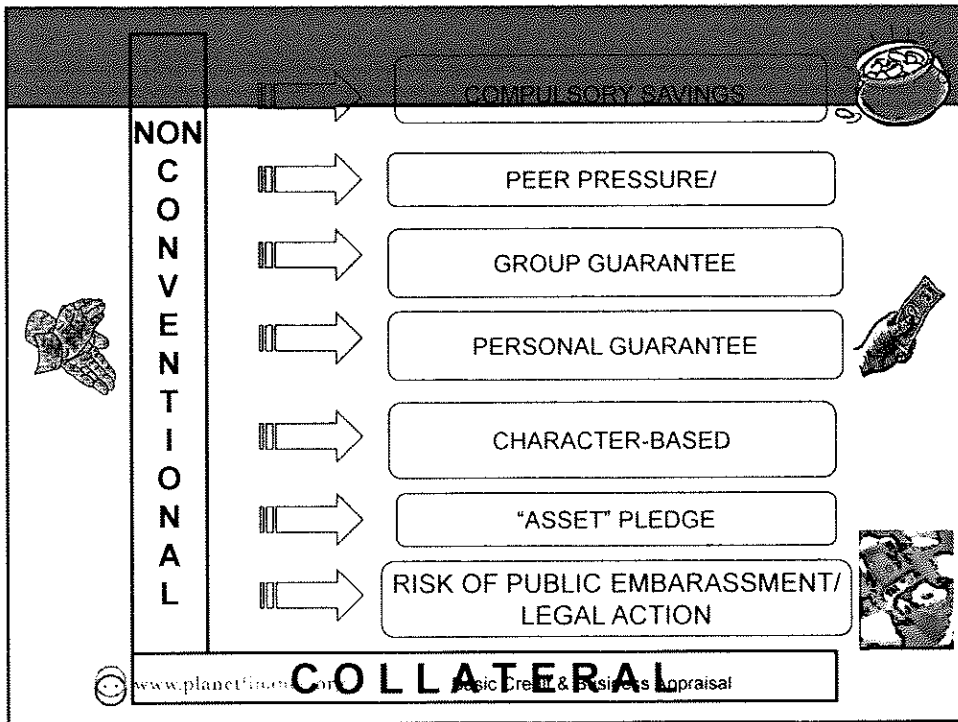
Session 7

Collateral Analysis









Compulsory Savings

- Compulsory savings are not available for clients to withdraw. They partly guarantee the loan.
- By being required to set aside funds as savings, borrowers are restricted from utilizing those funds in their business activities.
- Do have positive impact on the clients by smoothing out their consumption patterns.

Savings

- These savings are available for withdrawal only at the end of the loan term, providing the loan has been repaid in full.
- Demonstrate the value of savings practices to borrowers
- Serve as an additional guarantee mechanism to ensure the repayment of loans

Savings

- Demonstrate the ability of clients to manage cash flow and make periodic contributions
- Help to build up the asset base of clients.

Peer Pressure

- used in-group based method where the peers apply pressure on the defaulting members, to ensure that they pay.
- The need to be in good standing in the group ensures the members meet their loan repayment obligations

Group Guarantees

- MFIs facilitate the formation of groups whose members jointly guarantee each other's loans.
- Guarantees are either implicit guarantees, with other group members unable to access a loan if one or more member's are not current in their loan payments; or
- Actual guarantees, with group members liable if other group members default on their loans.

Group Guarantees

- Members can also contribute to a group guarantee fund, which is used if one or more borrowers fail to repay.
- The MFI seizes the fund to the extent of the defaulted loan, with other group members making up any shortfall. Failure to do so means that the entire group no longer has to access credit.

Character Based Lending

- This involves lending to people based on the good reputation in the community.
- Prior to making a loan the credit officer visits various establishments in the community and asks about the potential clients' character and behaviour.



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Risk of Public Embarrassment

- Often the approach involves threat to embarrass the clients in front of their families, peers;
- And neighbours, through public notices in local print media, or announcements made at the community meetings of the list of borrowers who do not repay.



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Assets Pledge

- Regardless of the actual market value of the assets owned by the borrowers, the act of pledging assets and the consequent realization that they can be lost causes the client to repay the loan
- This sends a message to other borrowers that the MFI is serious about the loan repayment

Risk of Legal Action

- Depending on the agreement, MFI's could take legal action, which could involve repossession of pledged household items, public auctioneering of the items, or civil jail for non-payment.
- Sometimes, simply the risk of legal repercussion is enough to encourage repayments

Personal Guarantees

- The client enlists friends or family members to provide personal guarantees.
- This means that in the event of the inability of the borrower to repay, the person who has provided a personal guarantee is responsible for repaying the loan.



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In Accepting Collateral

The credit officer should have answers to the following questions?

- Is the collateral offered by the client a good value for the loan?
- How fast is the collateral offered convertible into cash?
- Is the collateral free from encumbrances?
- Are there any conditions attached to collateral?




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Collateral Analysis

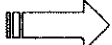

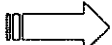


General Principles of Good Collateral

- Easy to value
- Stable in value/durability
- Free of encumbrances/unassailability of title
- Easy to obtain title to
- Easy to realize/marketability

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COLLATERAL MANAGEMENT

WHAT
is
acceptable
Collateral
(conventional)?

Ownership is easy to verify


Easily & cheaply seized

Cheap to convert to cash

Relatively cheap to store or manage

Value remains relatively stable over time

Have high personal value to clients

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