Alternative risk assessment and guarantee mechanisms adapted to the very poor

The problem of collateral

Poor people, even if they can provide physical collateral, often cannot prove it in a formally accepted way. Many people in Huehuetenango lack even the most basic legal documentation, such as identity cards. This is the result of loss and destruction of registers during the recent civil war. The lack of an ID document, of course, effectively excludes them from access to any kind of official financial service.

In Guatemala, anyone who can prove to have peacefully occupied (possessed) a piece of land for ten years can register it on his name before a notary. Based on the resulting provisional document, he can later claim it as his property. However, the possession of land is negotiable, and therefore, in theory, a claim could be established based on such possession document.

> This paper discusses practices in a rural microcredit scheme in Huehuetenango, Guatemala, operated by a Federation of Farmer's Associations called ACODIHUE. ACODIHUE essentially caters to highland farmers with annual family incomes below US$ 2000, for whom they issue loans between US$ 100 - US $ 2000.
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> Credits are channelled through 14 local Farmer's Associations, which in turn are made up of about 250 local credit Committees. The original credit fund came from an internationally-financed rural development project and was placed in a local bank, under a Trust Fund Administration Contract. Decision-making on loans is delegated to the level of the local Committees.

This form of land acquisition looks simple enough, but it is really a complex and expensive procedure, and nearly impossible to accomplish for native people with little education (and therefore difficulty in understanding Spanish). It involves the services of a lawyer, who is evidently not available in rural areas, and the procedure can only be completed in two cities (Guatemala city and Quetzaltenango), for the whole national territory. In some cases, the cost of registration exceeds the market value of people's tiny plots.

Efforts to simplify procedures and encourage documentation of land possession and property are currently being made. Oftentimes, however, different people own titles on the same land, hence, official land titles are not real guarantees and this exercise is not likely to have much success.

Many people, especially the poorest, rent their plots or cultivate land under communal ownership. They will never have private land titles and thus cannot apply for a mortgatge on their real estate. For them, a few formal banks recently have begun to consider accepting alternative collateral, such as motorcycles, refrigerators, etc.

In theory, all kinds of goods, future harvests, etc. can be constituted as a guarantee for a loan. But even then remains the problem of documenting the claim. It invariably involves a lawyer, whose fee constitutes a heavy overhead on a microcredit, even if he charges the minimum.

Role of the local community

The lack of official documentation makes people unbankable, but it does not make them less credit-worthy. They are well known in their Communities, and nobody knows better whether prospective borrowers can be trusted than their own neighbors, who have known them for years. Therefore, other members of the local community can be very helpful in the selection of credit subjects.

ACODIHUE gives credits only to members of its member Associations. These Associations, in turn, consist of local Committees, each with at least 10 members, not belonging to the same family. Committees are registered before the local authorities and each member pays a (small) membership fee to the Association.

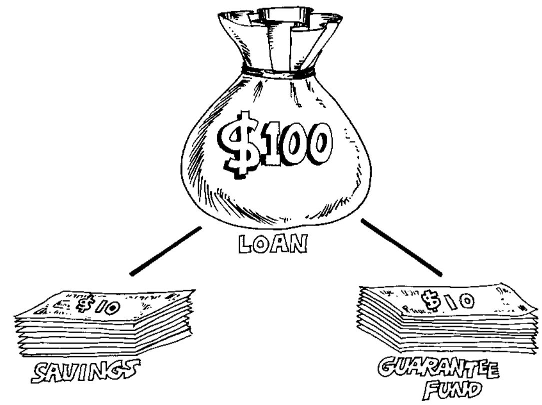
The local Committee approves all credit applications which are presented to the Association for re-evaluation before being handed over to ACODIHUE. Established rules ensure that the second evaluation is independent. For example, the president of the Association cannot approve a credit in favor of his own local Committee.

There is a limited number of well-defined credit lines, and in the first instance, credits are given for productive investments only (no consumption loans).

Guarantee funds

Unlike other microcredit schemes, such as the Grameen Bank, ACODIHUE did not abandon the idea of collateral altogether. Like in many other Latin American countries, the concept of "credit" had been tainted as a result of the lax practices of certain development banks. There were cases of people who had obtained loans but were never prompted to repay them, and eventually got away with it. Although the situation was not dramatic, the equation "credit equals gift" had taken hold in some minds. The philosophy was therefore: **where no executable collateral can be secured, the community can still be made financially co-responsible for the loan.**

In applying for a loan, each applicant makes a compulsory deposit of 10% into his personal savings account. These deposits accumulate with consecutive loans and serve as an individual guarantee. If no physical collateral can be presented, loan applications are made collectively and an additional 10 % of the loan value has to be deposited in a collective guarantee fund.



If the borrower fails to repay the credit, his cumulated savings account is forfeited. If this is insufficient, the rest is drawn from the Committee's guarantee fund.

The collective guarantee fund is not cumulative. Once the credit is paid back by **all** the participants in the collective loan, it becomes available to guarantee a new credit application. Only the difference to 10 % of the new credit value is to be deposited. If the new credit is smaller than the former, the difference is subtracted from the amount to be deposited as individual saving.

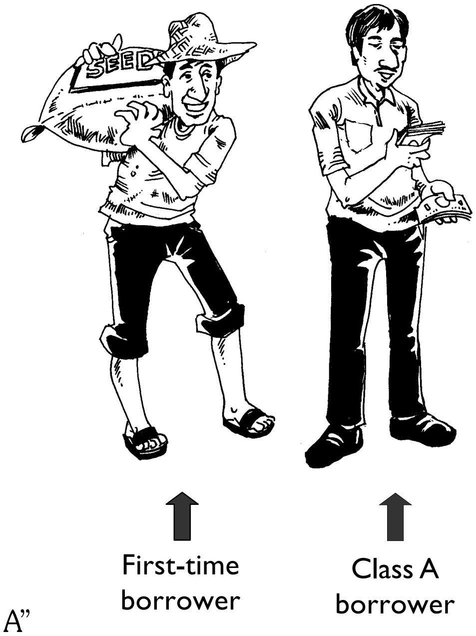
At first, the collective guarantee fund was kept at only 5 % of the loan value. Although this worked well in most cases, in some communities, it was insufficient to secure adequate pressure on prospective defaulters. Therefore, it was increased to 10 % as a general rule. However, some Associations decided to go even further, maintaining 20 % of the credit value in a collective guarantee fund. It is thought that this, in addition to the 10 % indidivual savings deposits, would be too much for a starting microcredit scheme.

The concept of local credit groups with collective responsibility is not new. It has been successfully applied in communal banks since the late 19th century. More recently, the Grameen Bank in Bangladesh was extremely successful with very strictly structured credit groups. ACODIHUE never attempted to have such deep impact onto people's lives as does Grameen Bank. At the same time, it requires a collective guarantee fund, deposited **before** obtaining the loan. Such guarantee is more real than trust in people's honor alone. The more people are exposed to failed collective credit schemes or to formal credit **with** physical collateral, the more difficult it is to implement entirely trust-based systems.

If a member retires from the scheme, he receives his savings plus the compounded interests, as well as his contribution to the guarantee fund also plus interests. If a guarantee fund is forfeited, each member's contribution is executed proportional to his credit, large borrowers contributing more than small ones.

Retirement is only possible if the local committee has no debt overdue. The local Committee must give written permission for retirement of its member, unless it has no credits pending at all. Retirement is final: re-application is not possible for several years. Without this rule, members would retire after each loan and not accumulate savings.

Classification of clients



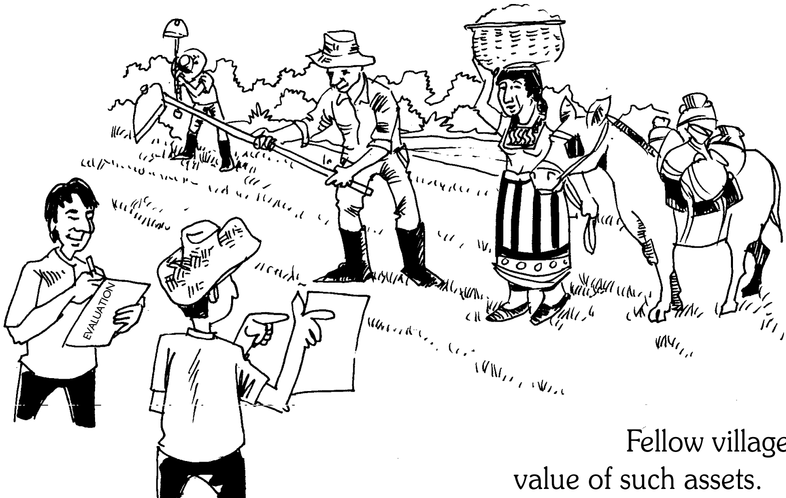
Working with less than 100 % collateral (collective guarantee fund) is highly risky in the first credit cycles. After that, the individual savings accounts begin to guarantee a substantial part of the loan. The worst risk is the defection of an entire Committee. Therefore, the **loan amounts should be limited** in the first credit, both per individual borrower and per Committee. In ACODIHUE, collectively guaranteed credits are not allowed to rise beyond US$ 500. However, taking into account diminishing risk with rising individual savings, there is no reason to stick to such limit for long-time clients.

> "Class A clients" are those who have no delayed payments in previous credits.

The **type of credit is limited** also. First time borrowers would only get credits in kind (fertilizers, animals, machines). Credits in cash would be given only to "class A" clients with at least three reimbursed loans. The maximum amount of such loans would be based on their cumulated savings.

Finally, the **duration of the loan is limited.** New clients would be given one production cycle (maximum one year) loans. Only clients who have proven reliable with such small amount / short time transactions would be entitled to longer term credit (up to five years).

Evaluation of collateral



In case a client offers a collateral, the local community can also be involved in its evaluation. First of all, fellow villagers know exactly which land, animals etc., genuinely belong to the prospective borrower. Oftentimes, outsiders such as bank's employees would be shown land or assets that are in fact not the client's property.

Fellow villagers are also the best judges of the real value of such assets. Imagine a plot of land is to be sold to repay a loan. Since it is likely to be a small lot in a remote rural area, interested buyers will most likely be members of the same community. Therefore, the best estimate of the value of the asset is what local community members are willing to pay for it. Outsiders, like bank's employees, can easily be misled by the villagers, or may apply evaluation rules that are not suitable for the local market. Moreover, the evaluation of assets in remote areas by specialized personnel is very expensive, compared to the value of the loan.

Rules have to be established to ensure the independency of the evaluation. In no case the prospective client can be allowed to evaluate his own, a relative's, or a close friend's collateral.

Pressure applied at different levels

As long as one member's debt is overdue, the entire local Committee is excluded from new credits. Similarly, if the overall overdue debt rate of an Association rises above 5 %, the whole Association is suspended. In the first instance, the borrower is urged to pay by peers in his own Committee. In a second stage, pressure will also be exerted upon people who actually did pay their debt, who in their turn will exert even more pressure on the non-payers.

In the original concept, guarantee funds would cover only the debts of members of the same local Committee. However, in several occasions, Associations decided to forfeit the collective guarantee funds of all of their Committees, including the solvent ones, in order to cancel the debt of a defaulting Committee. This makes sense, since the debt of one or a few Committees could block off new loans to the entire Association. It is therefore logical that guarantee funds function up to the highest level of the organization (first individual savings are executed, then the local Committee's guarantee fund, next the funds of the other Committees of the Association, and finally those of other Associations). This, however, would not have been accepted in Huehuetenango. ACODIHUE's area of intervention is ethnically, culturally and economically so diverse that people could not be made to accept co-responsibility for the debts of fellow borrowers beyond their own municipality.

Clients' identification with the system

In Huehuetenango, the described mechanisms of delegating decisions and responsibilities to the local communities strongly promoted the identification of clients with "their" credit fund. In fact, ACODIHUE's credit fund came from an external source and people were never told that it was "theirs." (In other projects, such assertions had proved to be counterproductive.) Nevertheless, the Associations developed a genuine sense of responsibility for it. This has helped greatly to establish a sustainable rural credit system.

Further reading

http://www.angelfire.com/ab/acodihue/QUIENACODIHUEPUB.html (in Spanish)

http://www.microcreditsummit.org/

http://www.grameen.com/

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