Micro-loan programs

In general, poor people throughout the world suffer from a lack of access to financial services. Put yourself in the shoes of a poor Filipino carpenter who is strapped for cash because of unexpected medical bills, theft or destruction of property, illness that has prevented him from working, or simply the inability to "get ahead." To buy materials for the day's work, he goes to the local moneylender who makes daily loans. He is offered a loan that is structured according to a common arrangement known as the "5/6 rule." It works this way: a borrower receives five pesos in the morning and must pay back six pesos that evening. This amounts to an interest rate of 20% daily, or roughly 7,200% per year--an oppressive arrangement in any culture. Such small loan amounts are of no interest to commercial lenders, even if he could qualify.

Enter micro-lending. Micro-loans are very small loans, usually ranging in amount from $25 to $100, although some may reach as high as $1,000. Most loans are short-term, from a short term of a few weeks to a longer term of six months to a year. They typically involve equal weekly payments such that the loan plus interest are repaid by these payments—no balance due at the end of the loan term. Most loans are for working capital investment—merchandise, supplies, fuels—and almost all are for the production of income.

There is a dire shortage of capital in poverty-stricken areas of the Third World. Of course, capital is critical to economic progress, not capital just as money, but in terms of the investment in productive equipment that money and credit enable. When most of the people in a society are living at a subsistence level, there is no excess to sell and no one with the surplus goods or money with which to buy. Surplus is necessary to allow investment, which in turn is the key to increased productivity, which is the source of surplus and economic progress. Without surplus there is nothing available to invest, and yet without investment there can be no progress.

In a modern economy, financial markets make it possible for ideas to be realized by allowing those who have more funds than they currently need to make those funds available to those who need more than they currently have. New products or services are brought to market because those with the idea and necessary background are able to obtain the funding required to make the idea a commercial reality. Financial markets are practically non-existent in primitive economies, so an infusion of investment funds is therefore essential to economic progress in these areas.

In some cultures where funds might be available in general, they might not be available to minorities, including those who convert to Christianity. In certain Muslim and Hindu cultures, for example, converts to Christianity may be cut off from borrowing opportunities, from employment opportunities, and even from their families. Here the Christian "family" can come through with support needed to allow a family to earn a livelihood.

The most successful developmental micro-lending programs have some key features in common:
(1) Loans are made to groups rather than to individuals—In the case of the highly successful Grameen Bank in Bangladesh, the basic building block of the loan system is a self-selected group of five non-related individuals. Each member is liable for her own loan, but all five are mutually liable for the loans made to other group members. For this reason, members are very careful about who they enter into a group with. In effect, the borrowers, not the lender, evaluate the creditworthiness of prospective group members, which reduces the cost of credit analysis to the lender.

Of course, each member's ability to service her loan depends not only on her dependability and trustworthiness, but also on the success of the project being financed. As a result, group members are also interested in the nature of the project and the ability of the group member to complete the project successfully. On an ongoing basis, group members provide business advice, encouragement, and even discipline as they consider necessary to ensure repayment of the loan. Although some micro-lending organizations also provide business training, this is in fact a separate role, properly considered under "Micro-enterprise Development." Grameen Bank employees are instructed to tell loan applicants, "We have money, but we don't have business ideas."

(2) Availability of future, larger loans is conditional on timely repayment of current loans. In the case of the Grameen bank, the five group members obtain money in stages. The most needy group member receives her loan first. After a few weeks of timely repayment have transpired, the next most needy member receives her loan, and so on.

The promise of future loans is regarded as critical to ensuring current payment. Although the group members are familiar, they cannot be related. In one African setting the rule is expressed in this way: group members cannot share the same cook fire. Meaningful peer pressure is critical to the process, and a number of programs claim repayment rates in the neighborhood of 98-99%. When a member is unable to make timely payments the other members often make them up from their own resources. If the delinquent borrower's problems are other than temporary, it is not unusual for the other group members to go to that person's place of business or home and take inventory or other items to make up the shortfall.

(3) Interest is charged to cover costs of operation and ensure the program's sustainability. Most micro-loan programs exist to fund income-generating enterprises, as opposed to loans made for charitable purposes to alleviate destitution or suffering. This is distasteful to some Christian missionaries, who see this as imposing further hardship on the poor they intend to serve. However, there are some points that must be considered:

a. First, providing a loan project is costly, and it is arguably appropriate for those who receive the benefits to contribute toward that cost. Ideally, a program that is initiated by western missionaries (who are paid to enable a mostly western lifestyle in the Third World) will as quickly as possible be conducted by nationals, who must be paid a salary. Micro-loan programs are costly to initiate and operate, and these costs of operation must be covered by program revenues or by other contributions—contributions that could be used elsewhere if not to support the loan program.

Even if the costs of conducting the program were negligible (If they appear to be, something has been overlooked!), inflation will undermine the value of a loan portfolio and threaten its viability. To illustrate, assume that a micro-loan program is initiated with a fund equal to US$10,000. Let's say that this money is loaned out several times over during the next year, with a 100% repayment rate--no defaults at all. If inflation occurs at the rate of 10% over the course of the year, that $10,000 loan fund is worth only $9,000 in terms of purchasing power. The only value money has is based on what it will buy, so the ability of this program to serve its constituents has been reduced by 10% over that year due to inflation. Interest is simply the rental charge for money, and that charge is needed to cover operating expenses and compensate for inflation.

It is widely recognized in development ministry that some types of programs are unlikely ever to be self-supporting, and therefore sustainable in the long term. Micro-loan programs are one of the few that can be self-supporting such that other resources can be used to provide worthwhile programs that are not self-supporting such as evangelistic outreach, care of orphans and widows, and many educaito0nal programs.

b. One could argue that one role of business and economic development ministry is to educate poor people in how business works, to provide them with the tools required to be successful in a competitive and dynamic marketplace. Failure to charge interest ignores the *time value of money*, the reality that money has value in use and therefore has a market-determined cost for that use. Pretending that money has no time value is misleading and unrealistic.

In the summer of 2000, I interviewed the Uganda director of FINCA, one of the world's largest micro-lending organizations. For decades it has provided relatively low-cost financing to many thousands of poor people who would not have received it otherwise. In our meeting he was very guarded, wondering what my purpose was in asking about how FINCA's programs were structured. Once he became aware of my interest in initiating a micro-loan program in Jinja, Uganda, he clearly stated his concern: Although FINCA is a non-profit non-governmental organization, it is required to cover its operating costs, and he was not keen on another organization undercutting him by giving out interest-free loans.

Given the importance of charging interest to the sustainability of micro-loan programs, the unrealistic and harmful lessons taught when money is offered free, and the potential for undermining beneficial programs that must charge interest, it is not advisable to offer "interest free" loans to fund income-generating enterprises. "Loans" made for charitable purposes with no interest and with no serious expectation of repayment are properly characterized as gifts or grants, and the correct terms should be used to prevent misleading the program participants.

<u>Conclusion</u>

A couple of years ago, I received an email from a missionary who was interested in initiating a micro-loan program. He described briefly the key aspects of the proposed program, several of which I had concerns about. I explained that a great deal of harm can come from a program that is not well structured, and suggested that he enroll in one of the online course offered by the Chalmers Center for Economic Development (See Links). I even offered to pay the course fee. He responded that he did not have the time to take a course in it—far too busy. I wish I had responded, "Then you really don't have time for a micro-loan program." Money change things, especially relationships, when the missionary becomes a dispenser of loans. Exceptional care must be taken

Before initiating a micro-loan program, it is critical that the mission effort research the existence of other programs. Which ones exist? What elements of the community do they serve? What elements are excluded, and why? What are the terms of financing and how do those terms compare to "informal" credit providers? Some years ago I read this bit of advice with regard to identifying a ministry" "Just because something needs to be done doesn't mean you're the one to do it." What special training or gifts do you or other team members possess that will allow you to organize and supervise a program that will provide blessings to all participants?