Adverse selection and moral hazard in group-based lending

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Chapter 4 Eritrean Microfinance Institutions

4.1 Introduction

This chapter deals with the two microfinance programs that are active in Eritrea. These programs are the Southern Zone Saving and Credit Scheme (SZSCS) and the Saving and Micro Credit Program (SMCP). Both programs make use of group-based lending with joint liability and both follow similar basic procedures.

Chapter 4 has two main sections. Section 4.2 deals with the description of SMCP: we will illustrate the background, the objectives and strategies, credit and savings methodology, and the organizational structure of the program. Section 4.3 describes the SZSCS in a similar way. The final section presents the conclusion.

4.2. The Saving and Micro Credit Program[1]

4.2.1 Background

The SMCP started to become active in 1996 as part of the Eritrean community development fund (ECDF). The source of funds for SMCP is the government of Eritrea, the World Bank (IDA), loans and grants from donors, and operating income. Since 2002 SMCP has been separated from the ECDF to become an autonomous unit operating under the Ministry of Local Government.

The main aim of the SMCP is to provide financial services to the vulnerable groups in both rural and urban areas of the country who have no access to formal banking services. The SMCP has been taking two different approaches with regard to the promotion of microenterprises. First of all, borrowing groups known as Solidarity Groups (SGs) organized in Village Banks (VBs) form the backbone of the program. This

[1] This section is based on Afeworki, (2000) and SMCP (2002 and 2003).

category of borrowers belongs to tier I. Generally, the beneficiary individuals that fall into this category will obtain short-term microloans that do not exceed 10,000 Nafkas per loan. Over 90 per cent of the SMCP clients fall into this category; these borrowers have to organize themselves into groups of three to seven members in order to acquire any loans from the program. On the other hand, individuals who graduated from group-based lending and individual entrepreneurs whose credit requirements cannot be met through the tier I facility may have access to a tier II window. This window should enable individual clients without recourse to collateral to borrow up to 100,000 Nafkas. In this thesis we are interested in the tier I part of SMCP, which uses group-based lending.

4.2.2 Objectives and strategies of SMCP

The goal of the SMCP is to promote the private sector in Eritrea by encouraging the development and expansion of micro and small enterprises, to assist individuals and groups to increase their income generating ability, and to improve their earnings and the overall prosperity of their communities.

The program has three operational strategies to achieve its objectives. The first strategy is to provide access to saving and credit to individuals who are currently unable to get access to credit from formal banks. The second strategy is to strengthen community representative structures, from village to higher levels, and to involve communities in the development and sustainability of the program. Finally, it tries to establish a legal, regulatory and judicial framework for the microfinance sector of Eritrea so that the SMCP can become an autonomous financial institution that is organizationally and financially sustainable.

4.2.3 Credit policy and methodology of SMCP

The SMCP is based on the creation of autonomously functioning VBs, which typically serve 35 to 105 members each. The VB is administrated at the village level through a saving and credit unit consisting of three members. The village (*Kebabi*) administrator acts as a chairperson while the other two are solidarity group members. They are responsible for accounts and record keeping. These VBs create their own by-laws, manage their loan funds, and decide on loan requests. Thus, the SMCP delegates the responsibility of running VBs to these elected members.

Any citizen or group of people (irrespective of gender) that has limited or no access to credit from a formal financial institution may benefit from the SMCP credit, provided they agree to comply with the required terms of credit. While the SMCP's objective is to focus on the poor, there is no accurate data available on poverty levels in Eritrea, which makes it difficult to determine whether the poor are actually reached. The SMCP, together with the regional administration and other community leaders, analyzes the economic viability of an area in which it wants to set up a VB.

A potential borrower does not have to present co-signers or any physical asset as collateral. However, there are two conditions that serve as a form of collateral. The first condition is that solidarity group members will become eligible for loans only after having successfully accumulated mandatory savings equal to 10 per cent of the amount they want to borrow within a period of three months. The second condition is that the group is jointly liable for repayment of all loans made to group members, and no new loans are provided until all outstanding loans have been paid back. If a group fails to repay loans, it may be banned from all further programs.

a) Group formation and training

Once a village or town is identified by the SMCP as a potential area for credit promotion, the first step is to call a meeting with the village (town) community and explain how the program works. The moment the community agrees to the terms and conditions, a village credit committee is elected. The committee will be trained in the VB training center. The training usually starts with a discussion of the experiences with loan programs in other villages. In general, training events will cover subjects such as bookkeeping and recording, loan approval procedures; loan recovery and preparing/writing simple business plans. After the training of the VB officials, the other members who have organized themselves into solidarity groups will be trained. Although the credit promoter (an employee of the SMCP) takes the leading role in training these solidarity groups, the committee is expected to train the solidarity groups on how the scheme works.

Beneficiaries will be eligible for SMCP credit if they are members of a SG. Here are some of the requirements for SGs to fulfil.

- The SG has to be formed through a process of self-selection by individuals who agree to the joint liability principles of the program and who trust each other.
- There cannot be more than one member from the same nuclear family (husband, wife and children) in a SG. However, members of the same family can join different SGs.
- SG members will have to accumulate savings in order to be eligible for borrowing. The willingness to save demonstrates a group's solidarity and its commitment to the program.
- SG members must be prepared to pay the registration and loan fees that are required by the leadership of the VB.
- In case different loan cycles and loan sizes occur within one SG, all SG members must agree on the terms and be ready to cosign for each other.
- Loans forwarded to SG members must be used for additional working capital or new investment and not for consumption.

b) Loan processing and approval

Individual members must submit their loan application including their business plan to their SG for screening and approval at an early stage. A loan request will be endorsed if the entire SG agrees. The group leader of the SG will then hand over the approved application to the VB for approval. The VB will examine the application and make a final decision. However, the VB has the mandate to reject the credit application formally, informing the SG on the cause for the rejection. Finally, after confirming that the loan processing procedures is in order, the regional SMCP's credit officer will promptly pay out the required funds to the VB. In the past, the procedure and the paper work associated with the loan issuance, approval and disbursement was elaborate (especially in case of repeat loans). Although this system offered control over the flow of funds, it increased bureaucratic procedures and raised the transaction costs to the borrower and the program.

The program has seven loan cycles, and the loan size increases gradually. The first loan cycle starts at 1,000 Nafkas while the maximum is 10,000 Nafkas. In some cases, however, a fresh borrower may be allowed to start at a higher cycle if the committee can justify the amount. A good example of this is when the new borrower wants to buy an ox, for which he requires 3,000 to 4,000 Nakfas. At the same time, borrowers are allowed to repeat the same loan cycle.

Borrowers and the credit officer get together and select the maturity period and install payments for the loan. Receiving subsequent loans depends on the repayment of the previous loan. Unless all SG members repay, individual members are not eligible for a next loan cycle. Thus, graduation to the next cycle always entails repayment of previous loan commitments by all SG members.

c) Savings and interest rates

The SMCP uses compulsory, locked-in savings of group accounts. The amount of compulsory savings from SGs has grown in recent years. The SMCP and the VBs are not legally authorized to use savings for credit purposes. At present, all savings mobilized by the SMCP are deposited in the CBE in the name of the VBs.

The SMCP charges 16 per cent annual interest rate for tier I clients, which is higher than what the commercial banks in Eritrea charge. The interest rate is based on the following assumptions: a) the cost of funds is 8 per cent; b) the cost of administration of the loan portfolio is 6 per cent; and c) the loan loss provision is 2 per cent. The declining balance method is applied when calculating the interest rate, which means that the interest rate is calculated after reducing part of the principal that is already repaid.[2]

4.2.4 Organizational structure and performance

Eritrea is divided into six administrative zones called *Zobas*, 59 subzones, and 2,606 villages clusters, organized into 701 legally registered administration villages (*Kebabis*). In 2002, SMCP covered all administrative zones (although in one zone the scheme is still quite new) and 49 subzones. In 2002 the program operated in approximately 158 administrative villages, consisting of 519 villages. This is an increase of 2.5 per cent compared to previous year. In the same year the program was organized into 162 VBs, serving 12,416 active clients. This number was 24 per cent higher than in 2001. Total disbursement of funds by the end of the year 2002 was approximately 23 million Nafkas, a 31 per cent increase from 2001. Table 4-1 shows a summary of the data for SMCP.

The degree of sustainability can be assessed by using the operational self-sufficiency index (OSSI) or the financial self-sufficiency index (FSSI). The assessment of the SMCP's organizational and financial past performance (July 1996-December 2001) is done by a simple trend analysis.

The operational self-sufficiency index shows the extent to which operating income covers operating expenses and provision of loan losses. As we can see from table 4-1, for the 1998-2002 period the program was able to cover its operating expenses from its income. The cost per unit of currency lent (CPUCL) indicator shows how much it costs to lend one unit of a country's currency. It is calculated by dividing all operational or financial expenditures by the loan amount disbursed: the lower the ratio, the higher the efficiency. For instance, in the year 1998 it cost 3 Nakfa cents to disburse a loan of 1 Nakfa currency. In the case of SMCP, the

[2] For instance an individual receives a loan of 100 Nakfas against an annual interest rate of 16 per cent. In the first month he pays 10 Nakfas. The remaining principal in the second month is (100 minus 8.67) 91.33 Nakfas.

trend of CPUCL shows ups and downs, and it is not easy to see a clear trend.

Table 4-1 Performance of SMCP, 1998-2002

	1998	1999	2000	2001	2002
VBs	76	85	88	146	162
Members	6,010	6,339	6,204	10,763	13,891
No. of loans	5,477	5,779	5,942	10,304	11,492
Loan amount*	8,902,520	9,184,808	9,259,711	17,617,584	23,037,580
Savings	1,199,498	1,466,860	1,669,487	2,709,593	3,873,599
Repayment	2,209,336	na	na	11,253,827	24,230,836
Delinquency rate#	20.4	7.12	5.96	2.71	2.56
OSSI	136.43	137.41	140.53	150.86	na
CPUCL$ (operational)	0.03	0.08	0.12	0.05	na

Source: SMCP (2002 and 2003)
Notes:
* Amount of loans, savings and repayments are all in Nakfas
# Delinquency rate: amount of payments more than 30 days overdue/total outstanding balance of loan portfolio
$ Operational expenditure includes expenses for salaries, running costs, loss funds due to defaults, and payments of interest for savings
n.a. is not available

4.3 Southern Zone Saving and Credit Scheme[3]

4.3.1 Background

The Southern Zone, which is one of the six administrative regions of Eritrea, consists of up to 1,000 villages inhabited by about half a million people. When the Ethiopians withdrew in May 1991, the government discovered 1.7 million Nakfas (US$ 243,000) in a bank account, which belonged to 67 villages and cooperative shops in the highland province of

[3] This section is based on ACORD (1996, 2000, and 2003).

Seraye. The government sought ways to pay this money to the inhabitants of the region. In 1992, the governor of the then Seraye province contacted a UK-based NGO, the Agency for Cooperation and Research in Development (ACORD) office, and requested its assistance to the develop credit scheme to utilize the available funds. ACORD has considerable experience with income generating activities in the region, especially in the Sudan. This led to a four-year credit and savings scheme, which started in 1994 with a one-year pilot. In addition to the relatively modest sum that was initially invested in the scheme, ACORD contributed a total of £ 860,000. This consisted of £ 286,000 in 1994, £ 230,000 in 1995, £ 188,000 in 1996, and £ 155,000 in 1997.

4.3.2 Objectives and strategies of the SZSCS

The objective of the scheme is to improve the living conditions of the poor in the southern region. The program has three operational objectives. Most importantly, it wants to give people who do not have any dealings with the formal financial sector, access to credit. Secondly, it wants to strengthen community representative structures and build institutional and human capacity so that in the future members can run their VB by themselves. Finally, it aims to establish a legal base, which is organizationally and financially sustainable.

The scheme is aimed at the needs of the poor, especially women; it makes use of group solidarity and relatively low loan ceilings and regular savings requirements. The approach is participatory, and its clientele is a mixture of groups of which the majority consists of poor people. Hijacking of the benefits of the program by middle class members or by men is prevented through the social control of the elected village committees.

4.3.3 Credit policies and methodology of the SZSCS

The foundation of the scheme is an assembly of SGs called Credit and Saving Groups (CSGs). These CSGs elect five persons (at least two women) as members of a village or town Credit and Saving Committee (CSC). This committee is a representative of the CSGs. At the next level we find the Sub-Provincial Credit and Savings Councils (SPCSs), which are formed by elected representatives from CSCs. SPCSs are responsible for the development and amendment of policies and also for training and research, but they are not directly involved in the credit screening of members.

a) Group formation and training

The moment a priority area, a village or group of villages (*Kebabi*), or potential members in a provincial town are identified, credit promoters from the scheme call a meeting with the village community and explain how the scheme works and how the community may benefit from the scheme. Once a group of people, ranging from 35 to 100 persons, has shown an interest in the scheme, it will receive further training and is encouraged to start saving to show that their intentions are sincere. The SZSCS follows the group-based lending principles, and potential borrowers are trained to organize themselves into groups ranging from three to seven, called SGs. Every SG is represented by its group leader, who will have regular contact with the CSC. A credit promoter will represent the scheme.

b) Loan processing and approval

Loan requests by individual members are discussed within the SG. A loan request will be endorsed if the group as a whole agrees. Groups may accept or reject a proposal because a group guarantee is involved. Loan requests that are agreed upon go to the CSC for screening. The committee meets once a month and screens loan applications immediately. Loan applications endorsed by the CSC are forwarded to the headquarters for approval, at which point the loan becomes effective and the approved amount is disbursed to the member. Loans range from 1,000 to 8,000 Nafkas. In the past the loan size enabled the scheme to adopt a progressive system, which helped poor clients to expand their investment gradually. Nowadays, rigidity concerning the loan size and maturity period is almost totally eliminated. Borrowing members who want to start at a higher loan scale are allowed to do so, provided that the project requires more funds than the initial amount of the loan and that the other group members agree. Repeated loans are only granted if the previous loan has been successfully repaid. This shows the strict adherence of the program to the joint liability principle. Borrowers can choose the loan and instalment terms after discussing this with their credit promoter. Table 4-2 shows the amount of loans in each loan cycle and the possible maturity periods of both programs.

Table 4-2 Maximum loan sizes in the different loan cycles in Nakfas

	SZSCS		SMCP	
	Loan size	Maturity	Loan size	Maturity
1.	1,000	3-24 months	1,000	3-24 months
2	2,000	3-24 months	2,000	3-24 months
3	3,000	3-24 months	3,000	3-24 months
4	4,500	3-24 months	5,000	3-24 months
5	6,000	3-24 months	7,000	3-24 months
6	7,000	3-24 months	8,500	3-24 months
7.	8,000	3-24 months	10,000	3-24 months

Source: SMCP (2002) and ACORD (2000)

c) Savings and interest rate

The savings policy introduced by the scheme is obligatory in two ways: (i) first, a group will not be recognized before it can produce a regular savings of 5 Nakfas per month; (ii) savings are linked with loans as a collateral, in addition to the guarantee offered by the group members.

Initially, the requirement was 25 per cent of the requested loan amount, but this was reduced to 15 per cent in order to accommodate poorer groups. Recently, the requirement has been further lowered to 5 per cent for female clients and to some extremely poor communities, but it increases with the amount of the loans. The scheme pays 7 per cent interest for individual savings and group savings deposited in commercial banks. The program is not allowed to use the savings for its loan business. During the early days the SZSCS used to charge an annual interest rate of 12 per cent per annum, which was raised to 14 per cent per annum in 1997. Since the start of the scheme, it obtained a subsidy from ACORD in the form of grants and technical assistance.

4.3.4 Organizational structure and financial performance

Originally, the program served only borrowers from the then Seraye province.[4] Today, it is active in the whole of the Southern Zone and in certain parts of other zones. As mentioned above, the SZSCS partially acquires its financial support from ACORD. Reliance on these funds raises questions whether this scheme can sustain in the near future without outside support.

The number of clients increased from 8,102 in 2001 to 9,157 by the end of 2002. The total loan disbursement by the end of that year was approximately 17.5 million Nafkas, a 30 per cent increase compared to 2001. At present, the scheme operates in 163 administrative villages, encompassing 527 villages – a 20 per cent increase compared to 2001. The number of VBs has increased from 8 in 2001 to 18 by the end of 2002. Table 4-3 shows summary data of the SZSCS.

[4] The Southern Zone is the most populated zone of Eritrea; the former Seraye province is part of the Southern Zone.

Table 4-3 Performance of SZSCS (1998-2002)

	1998	1999	2000	2001	2002
Villages/towns	110	199	242	429	527
VBs	3	5	5	8	18
Groups	979	1,430	1,556	2,147	2,493
Members	4,602	5,908	6,185	8,102	9,157
No. of loans	1,517	2,473	1,627	4,166	4,569
Loan amount*	3,143,150	4,132,900	3,995,904	13,375,900	17,372,984
Repayment	3,424,609	3,137,416	3,574,530	Na	12,846,874
Savings	423,747	424,038	359,856	2,547,632	3,700,104

Source: ACORD (2000, 2003)
Note:
*Loan amounts, savings and repayments are all in Nakfas

In the year 2000 the program covered 72 per cent of its costs with generated income. Table 4-4 shows that the program is making important progress towards achieving financial sustainability since 1994. The CPUCL indicator shows a slight rise in the last three years. Yet, one cannot really conclude that the SZSCS has improved its efficiency.

Table 4-4 Financial performance of SZSCS, 1994-2000

	1994	1995	1996	1997	1998	1999	2000
OSSI (in %)	22	16	33	64	89	72	72
CPUCL (operational)	0.54	0.19	0.13	0.13	0.19	0.21	0.22

Source: ACORD (1996 and 2000)

4.4 Conclusion

The two Eritrean lending programs started their activities in the mid-1990s. The programs have similar objectives: providing credit to the poor, who do not have access to formal financial institutions. Both programs use group-based lending in trying to reach the poor.

This description of these two lending programs in this chapter has made clear that their activities and lending policies differ from other Eritrean formal financial institutions, which were described in the previous chapter. While the Eritrean formal financial institutions are collateral-based and urban-oriented institutions, the two Eritrean microfinance programs are grassroots-oriented. In particular, they are group-based lending programs that substitute collateral with joint liability principles.