AVOIDANCE OF OVER-INDEBTEDNESS:
GUIDELINES FOR FINANCIAL AND NON-FINANCIAL EVALUATION

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the **smart** campaign

Keeping clients first
in microfinance

INTRODUCTION

"Avoidance of Over-indebtedness: Guidelines for Financial and Non-financial Evaluation" is a tool for financial service providers that want to incorporate good client protection practices into their evaluation processes for individual loan clients. Specifically, the tool provides guidelines for determining a loan applicant's capacity and willingness to repay a loan. A careful evaluation process is critical to **avoiding client over-indebtedness,** the situation in which a client cannot repay a loan without sacrificing his or her quality of life. Financial service providers have a responsibility to actively prevent client over-indebtedness.

The tool is divided into three parts:

I. Overview of the Individual Credit Process: The Smart Campaign's "Smart Lending"[1] tool provides details on how to apply the Client Protection Principles at each step in the individual lending process. This section summarizes that tool and demonstrates how it interacts with this tool.

II. Collecting Financial and Non-financial Data: Collecting sufficient data on loan applicants reduces the risk of client over-indebtedness resulting from loans that clients are unable to pay, or loans to clients who are unwilling to pay. This section describes database research and data collection. For each step in the data collection process, the tool outlines: 1) The institution's objective, 2) Client protection guidelines for the institution, 3) Additional process guidance for the institution, and 4) Related evaluation forms. **Annexes A, B, C, D, E and F** provide sample financial and non-financial data collection forms.

III. Evaluating Financial and Non-financial Data: After collecting client information, institutions must carefully evaluate client creditworthiness and debt capacity. **This section provides guidelines for:**

1. Financial and ratio analysis—provides ratios and guidelines for evaluating a client's business and household
2. Non-financial analysis—provides non-financial indicators and guidelines for interpretation
3. Development of the loan proposal—provides guidelines for setting the installment amount, loan amount, loan term, and repayment frequency

Annex G provides sample criteria for adapting loan terms based on various client risk factors.

THE CLIENT PROTECTION PRINCIPLES (short form listed below; for complete description, see www.smartcampaign.org.

1. Avoidance of over-indebtedness
2. Transparent and responsible pricing
3. Appropriate collections practices
4. Ethical staff behavior
5. Mechanisms for redress of grievances
6. Privacy of client data

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[1] "Smart Lending: Client Protection in the Credit Process," See: http://smartcampaign.org/tools-a-resources/100
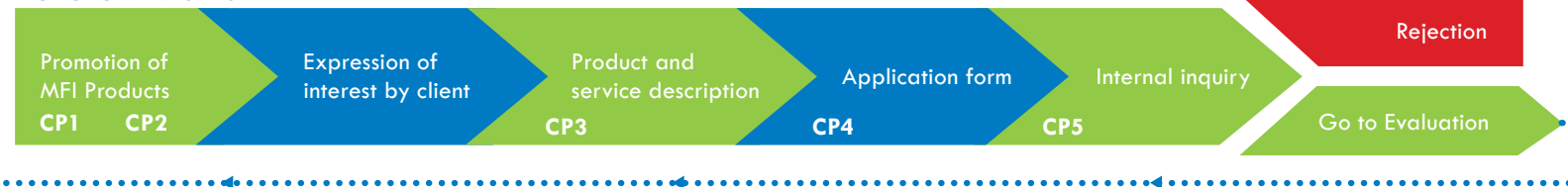
I. THE INDIVIDUAL CREDIT PROCESS

"Smart Lending: Client Protection in the Credit Process," is a complementary tool to the tool presented in this manual. "Smart Lending" provides guidelines for how MFI staff should incorporate client protection into the policies and operations of the individual lending process. The diagram below is used in the "Smart Lending" tool to describe the steps in the individual lending process.

The guidelines presented in this tool will focus on two phases in this process: "Evaluation" and "Approval." While "Smart Lending" provides general guidance on client protection during these phases, this tool provides guidelines for how to avoid client over-indebtedness, specifically.

CHART 1. THE INDIVIDUAL CREDIT PROCESS

PROMOTION AND SALES

Promotion of MFI Products **CP1** **CP2** → Expression of interest by client → Product and service description **CP3** → Application form **CP4** → Internal inquiry **CP5** → Rejection / Go to Evaluation

EVALUATION

Collection of non-financial data **CP6** → Collection of financial data **CP7** → Entry of data **CP8** → Internal inquiry **CP5** → Rejection / Go to Approval

APPROVAL

Credit committee & loan analysis **CP9** → Loan decision **CP5** → Rejection / Go to disbursement

DISBURSEMENT

Inform client of loan decision → Client & co-signers visit branch → Disbursement speech **CP10** → Finalize paperwork **CP11** → Disburse funds

COLLECTIONS & RECOVERY

Promotion of MFI Products **CP1** **CP2** → Expression of interest by client → Product and Service Description **CP3** → Application form **CP4** → Internal inquiry **CP5** → Rejection / Go to Evaluation

EVALUATION

Collection of non-financial data → Collection of financial data → Entry of data → Internal inquiry → Rejection / Go to Approval
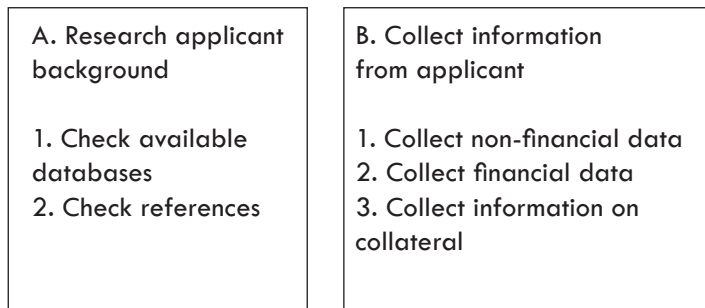
II. COLLECTION OF FINANCIAL AND NON-FINANCIAL DATA

Institutions must use financial and non-financial data to make loan decisions that minimize risks for both the institution and the client. The primary risk to the client is over-indebtedness resulting from a loan that the client either cannot or will not repay. Adequate data collection and analysis protect clients by matching the client with the most suitable product, loan size, term, and collateral requirements. Data collection and analysis can also reduce the number of already over-indebted clients who receive additional loans.

This section of the tool provides guidelines for **collecting client data**. The following section will provide guidelines for **evaluating client data**. Chart 2, below, describes the process of collecting applicants' financial and non-financial data for individual loans. After a loan applicant submits an application for a first loan, the institution should take the steps outlined below.

Chart 2. Process for Collecting Financial and Non-financial Data

A. Research applicant background

1. Check available databases
2. Check references

B. Collect information from applicant

1. Collect non-financial data
2. Collect financial data
3. Collect information on collateral

Box 1. General Guidance for Client Protection in the Data Collection Process

Institutions should observe the following general guidelines throughout the entire client data collection process:
- Follow the institution's Code of Ethics (which should apply to all interactions between staff and potential clients).
- Respect the privacy and confidentiality of applicant data.
- Refrain from judgmental questioning (e.g. Ask, "Do you have someone that helps you read important business documents?" rather than, "How do you understand important business documents if you don't know how to read?")
- Allow time for applicants to ask questions and receive satisfactory answers throughout the data collection process.
- Ensure that applicants know how to submit questions or complaints, should a problem or inquiry arise.
- Discuss why data are collected; in particular, discuss institutional values for careful loan evaluation to avoid client over-indebtedness.

A. RESEARCH APPLICANT BACKGROUND

The institution should obtain as much information as possible on the applicant from third parties. Consulting databases and applicant references is essential to ensure that the applicant has provided reliable information and that the institution should continue with the full financial and non-financial evaluation.

1. CHECK AVAILABLE DATABASES

Objective	Check the applicant's status in the institution's own database, plus any external databases: Central Bank credit bureau; private credit bureau; or data shared between institutions or available from national networks.
Client Protection Guidelines	Background research is the first step in protecting clients from over-indebtedness. This is particularly important when the local market is saturated and/or the client is known to have existing formal or informal debt. In the absence of credit bureaus, arrange information sharing on bad debtors with other lenders. The level of inquiry should intensify as loan size increases.
Process Guidance	The following data indicate the client is at risk for over-indebtedness: in substantial arrears, previously rejected, written-off, refinanced, restructured, in overdraft, and a history of late payment.

2. CHECK REFERENCES

Objective	Consult references to confirm information provided by the applicant, collect information on applicant's stability and trustworthiness, as well as their willingness to repay. References include: home and business neighbors, suppliers, and guarantors.
Client Protection Guidelines	References are the best source of information on the applicant's willingness to repay his or her loan. References are more likely than applicants to signal past problems with other lenders. A staff book of rules should include guidance on staff treatment of references and privacy of client data when speaking with third parties such as references and guarantors.
Process Guidance	In addition to gathering other pertinent information, ensure that staff gather thorough information on existing debt, both formal and informal. Use information to crosscheck facts provided by applicant. Verify existence of home, business, and suppliers.

Box 2. Database Research in Practice
Opportunity Bank Serbia (OBS) screens individual loan applicants using an 11-question form that requires data from the National Credit Bureau. The institution continues processing the applicant's application **only upon finding that**: 1. The applicant is not currently in arrears on loans, credit cards, guarantees or lease agreements in amounts which, when counted individually, exceed 5% of his/her monthly salary; 2. The applicant is not currently in overdraft on his/her bank accounts in an amount exceeding 5% of his/her monthly salary; 3. The applicant has not been in arrears in an amount exceeding 50% of his/her monthly loan obligations in the past 12 months; 4. The applicant has not exceeded his/her approved overdraft by more than 20% in the past 12 months.

OBS uses credit bureau data to help assess initial risk, existing debt levels, and whether to continue with further evaluation.

More information available here.

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B. COLLECT INFORMATION FROM APPLICANT

After determining an applicant's suitability for further assessment, the institution should visit the applicant to collect the most important information on capacity to repay, and additional information on willingness to repay. Information collection usually occurs during a home visit, business visit, or both.

1. COLLECT NON-FINANCIAL DATA

Objective	Learn about the applicant's character, management capacity, and family situation. Use questioning and visual observation (observe: stock, personal assets, employees, records).
Client Protection Guidelines	Explain what demographic and business information is needed for evaluation, and how it will be stored and used. Clearly ask about other outstanding debts and anticipated loan use, and compare with information obtained from other sources.
Process Guidance	The institution should "at minimum" collect the following non-financial information: 1) Applicant's business situation—experience, stability, and orderliness; commitment to the business; and business size and intended loan use. 2) Family and personal situation—characteristics of family and household; personal characteristics.
Forms	See **Annex A**: Sample non-financial business questions, and **Annex B**: Sample non-financial family questions.

2. COLLECT FINANCIAL DATA

Objective	Learn about the income, expenditures, assets, and liabilities of the applicant's business and family. Collect sufficient information to evaluate the client's ability to repay a loan, and to match the client with the appropriate loan product.
Client Protection Guidelines	Before collecting financial data, explain the consequences of over-indebtedness and why it is important to provide accurate information—stress honesty and integrity. Make sure applicant knows what information will be collected and how it will be used.
Process Guidance	Financial data collection should be systematic and include: 1) a joint business and household income statement (sales and cost of sales; operating expenses; other family income; family expenses) 2) a joint business and household balance sheet (current business assets and liabilities; fixed business assets and long-term business liabilities; and family assets and liabilities), and 3) a business seasonality analysis.
Forms	See **Annex C**: Model business and household income statement, **Annex D**: Model business and household balance sheet, and **Annex E**: Business seasonality worksheet.

3. COLLECT COLLATERAL INFORMATION

Description	Learn what guarantee or collateral the applicant can offer for the loan. Evaluate fixed assets offered as guarantees.
Client Protection Guidelines	Explain why assets are being recorded (e.g., for loan size evaluation & collateral) and what can happen to these assets in case of default. If applicable, describe under what circumstances client assets can be removed, and explain the process. Inform clients if savings will be taken in the case of default. The institution must develop a clear policy on what assets, if any, may and/or may not be registered as collateral. Excessive over-collateralization can harm clients if the collateral is liquidated. Careful consideration should be given to recording collateral that is critical to the client's basic quality of life.
Process Guidance	The institution should maintain a list of asset values by age and physical state so that collateral is evaluated uniformly. Loan conditions should rely on the client's cash flow; guarantees are a backup in case the business does not generate sufficient income to repay the loan.
Forms	See **Annex F**: Questions for collecting collateral information.

Box 3. Protecting Clients Through Transparency

Even during the promotions and application stages of a loan, institutions must provide clients with full product information, to ensure that applicants can make fully informed financial decisions. However, transparency does not begin and end with full disclosure of terms and conditions. In addition to providing full information, institutions must communicate with clients in a way they understand, taking literacy, financial knowledge and experience, and language into account. **At a minimum, clear communication with clients includes:**

- Use of local language(s);
- Use of plain terminology;
- Verbal explanation for illiterate clients and;
- Willingness to answer clients' questions to their satisfaction.

Collection of non-financial data **CP6**	Collection of financial data **CP7**	Entry of data **CP8**	Internal inquiry **CP5**	Rejection / Go to Approval

III. EVALUATION OF FINANCIAL AND NON-FINANCIAL DATA—INTERNAL INQUIRY

The previous section provided guidelines for the data *collection* process. Section II provides guidance for evaluating the data—the process of internal inquiry. Institutions must carefully evaluate client creditworthiness and debt capacity. Experience shows that **borrowers often have difficulty realistically assessing their loan repayment capacity,** making it imperative for lenders to have sound procedures for client evaluation.

Chart 3, below, describes the process of evaluating the financial and non-financial data collected from applicants. This section provides guidelines on protecting clients during each step of this process.

Chart 3. Client Data Evaluation

DATA EVALUATION

1. Financial and ratio analysis
2. Non-financial (qualitative) analysis
3. Development of loan proposal

Box 4. Guiding Principles for Data Evaluation

Institutions should observe the following general guidelines throughout the entire **data evaluation process**:

- Household surplus is the best indicator of the applicant's capacity to repay.
- Collateral and guarantees are a secondary source of payment and confirmation of client commitment to repay, but the lending decision should be made on the basis of repayment capacity.
- Loan approval limits should be adjusted as needed. During a period of system-wide delinquency, or in an over-saturated/overheated market, institutions should set more conservative standards for loan amounts, and number of outstanding loans from all sources.
- If credit bureaus are unreliable, outdated, or non-existent, the calculation of the client's repayment capacity should take into consideration the possibility of additional, non-disclosed debt.

A. RATIO ANALYSIS

Loan officers should conduct a thorough analysis and calculate a number of key ratios using the financial information collected. Ratios provide insight into the performance and status of the business, and its importance to the household.

The following nine ratios are basic indicators of the financial health of the applicant's business. These ratios are commonly calculated by the loan officer in the field during the evaluation process. Analyzing these ratios helps determine whether or not the applicant is a desirable candidate for a loan. Institutions must establish policies on acceptable ranges or cut-off values as benchmarks for each ratio. Suggested benchmarks are included in the table below.

Ratio Type	Basic Ratio	Description	Analysis Guidelines
Profitability	Gross profit/Sales	Measures the profitability of a single business as compared to similar businesses.	Ratios should be similar to that of businesses of similar size in the same sector or activity and in similar locations. If ratios are smaller than similar businesses, the business may not generate enough profit to repay the loan.
Profitability	Net profit/Sales		
Working Capital Rotation	Cash/Sales	Measures how cash on hand compares to estimated or actual daily sales.	This ratio should be used as a crosscheck. The client's cash on hand (at the time of evaluation) should reflect her reported or estimated cash sales. For example, if the client estimates sales at 1,000 per day but at 16:00 in the afternoon, she only has 200 cash in hand, the loan officer should probe and find out why she has so little cash. Additionally, working capital rotation should be similar to that of businesses of similar size in the same sector and similar locations.
Liquidity	Cost of goods sold/Accounts payable	Measures how often the applicant repays creditors (people from whom she has purchased goods on credit).	A higher ratio indicates that the applicant repays creditors more often, which is desirable. If this ratio is lower than the ratio for other similar businesses, ask applicant for an explanation of why suppliers (creditors) are repaid infrequently. Check with suppliers to verify applicant's explanation. Often used with the ratio above.
Working Capital Rotation	Accounts receivable/Sales	Measures how well the applicant collects on loans/credit sales provided to his/her own customers.	If this ratio is more than **50%**, loan officers should make a careful analysis of the applicant's cash flow, making sure he or she has capacity to repay the loan. By their nature, certain business activities may have high levels of accounts receivable because they sell most of their merchandise on credit and collect the cash payments at the end of the month.
Indebtedness	Liabilities + Recommended loan/Equity	Measures how much of the business's assets are paid for by lenders versus owners.	This ratio gives an indication of how easy it will be for lenders to recover their money. If this ratio is greater than **100%**, the business may become highly indebted and it may be unwise to provide the recommended loan amount.
Liquidity	Current assets/Current liabilities	Measures the ability of the business to meet short-term obligations.	The client should have enough current assets to cover current liabilities. If this ratio is lower than **100%**, it is likely that the client cannot meet repayment obligations.
Profitability	Household expenses/Total income	Measures the rate of consumption of the household.	Consider setting a minimum for the proportion of expenses that are covered by income. If expenses are **more than 50%**, proceed with caution. If the proportion is very high, **such as more than 85%**, the applicant may be unable to repay the loan if unexpected expenses occur.
Dependence	Other income/Total income	Measures the proportion of the household's total income that depends on income generated by something *other* than the business that would be funded by the institution.	If total household income depends heavily on "other income" (high ratio), the client is at risk for over-indebtedness. This is especially true when "other income" is generated from an unstable salary. A higher ratio may also reflect lower commitment to the business and/or proper loan usage. Consider setting an upper limit of **30% to 50%** for this ratio. However, if the ratio is higher, check for and take into account reliable sources of income.

B. NON-FINANCIAL (QUALITATIVE) ANALYSIS

Non-financial data analysis allows the institution to take qualitative information into account when evaluating potential clients. This information is especially important to determine client willingness to repay debt. Institutions should establish clear policies on which responses should influence the evaluation in a positive or negative manner, and which responses result in rejection of the applicant. The table below suggests non-financial indicators, as well as how to verify and evaluate the information.

1. NON-FINANCIAL BUSINESS DATA. (The questions below are provided in questionnaire form in **Annex A. Sample non-financial business questions**).
The table below suggests non-financial indicators about the applicant's business, as well as how to verify and evaluate the information.

Data collected	How to verify the information	How to evaluate the information
1. Business type & years in existing business	• Observe operations and inventory. • Ask questions to confirm applicant's understanding of business type. • Observe whether any investments have been made in the business. • Look for evidence of management skills.	• Caution: other similar businesses have failed or proven high-risk to the lender. • Caution: less than one year of experience. • Cancel the evaluation if there is no proof of business.
2. Ownership of business location & years at location	• Ask for documentation or a suitable reference confirming ownership or lease. • If applicant moves frequently, ask why.	• Positive: ownership or a long-term lease signals commitment to business. • Caution: unstable business location. • Caution: less than one year in that location.
3. Existence and type of business records	• Ask to see all records kept by applicant. • Check if records reflect business.	• Positive: complete, neat, and legible records indicate good management skills. • Cancel evaluation: records are false or fabricated.
4. Time spent in business	• Check if business is seasonal or temporary. • Ask customers/neighbors if owner is regularly present.	• Caution: business is not permanent or it is not the owner's main activity.
5. Location of business premises	• Look for customers in business. • Look for competitors near the business. • Look for vulnerability to fire, flooding, or theft.	• Caution: business is not in a sufficiently accessible location or is in a vulnerable location.
6. Improvements and investments	• Observe whether business is clean/orderly. • Ask about recent investments, improvements, and replacements.	• Positive: client makes regular capital investments, or recent investment in the business. • Caution: applicant shows no commitment to maintaining clean business, or has not invested in it.
7. Persons who normally work in the business	• Ask about # of permanent and temporary employees, and how many are paid/unpaid. • Observe employees present in the business.	• Caution: applicant does not exert financial and management control over the business.
8. Persons who will help to repay loan in case of difficulties	• Ask who will run business if applicant is absent or sick. • Ask who will take care of loan repayments in case of arrears. • Obtain verbal commitment to loan repayment from the guarantor, spouse or other contact.	• Caution: the business closes when the applicant is sick or absent. • Caution: the applicant will not indicate who would help to repay the debt in case of difficulties.
9. Intended loan use	• Ask about quantities and prices of goods sold. • Check these against prevailing market prices.	• Caution: the applicant's understanding of demand for goods/services or prices appears unrealistic or incorrect.

2. NON-FINANCIAL FAMILY QUESTIONS. (The questions below are provided in questionnaire form in **Annex B**. Sample non-financial family questions). The applicant's character and attitude toward the repayment of the loan are important factors for risk. Examining character and personal behavior is inherently subjective. However, loan officers can observe character traits systematically using examples from the table below.

Data collected	How to verify the information	How to evaluate the information
1. Level of education	• Check if applicant can read and write.	• Many microentrepreneurs have not received formal education. This is not an indicator of a lack of willingness to repay, but more education signals more competent business management.
2. Owner of applicant's home & years in home	• Look for evidence of ownership. • If applicant moves frequently, ask why.	• Caution: applicant "squats" informally or stays with relatives.
3. Number of household members & number of dependents	• Ask who lives in same house and benefits from the household income; include applicant in this calculation. • Ask which household members make no income; include relatives and non-relatives supported outside the home. • Compare with household income and expenses.	• Caution: expenses appear low relative to number of household members. These may be under-estimated. • Caution: number of dependents is high and only one family member is economically active.
4. Household members and dependents in school	• Compare with family educational expenses.	• Caution: expenses seem low and thus under-estimated.
5. Household members and dependents who are ill	• Compare with family medical expenses.	• Caution: dependents are sick and yet expenses are low.
6. Agreement of partner for the loan	• Ask for verbal commitment. • Get signature.	• Cancel evaluation if partner agreement for the loan is legally required and partner refuses.
7. Level of organization	• Check if/how applicant keeps receipts. • Check if house is tidy and orderly.	• Caution: applicant cannot find key documents. • Caution: house is untidy and disorganized.
8. Level of enthusiasm	• Observe how applicant sells products and the type of service provided. • Check if applicant occupies leadership positions in community.	• Caution: applicant acts carelessly, or behaves passively.
9. Discipline	• Check if applicant saves regularly. • Observe how children behave.	• Caution: if applicant has more than one negative reference.
10. Punctuality	• Check if applicant opens business on time. • Check if applicant pays utilities on time.	• Caution: applicant's business is frequently closed during normal operating hours. • Caution: applicant often pays bills late.
11. Openness	• Observe if applicant is uncomfortable providing information on income. • Observe if applicant volunteers information on important family situations.	• Caution: applicant is dishonest or hides essential information.

C. APPROVAL: FORMULATION OF LOAN PROPOSAL

Given the institution's analysis of financial and non-financial data, and taking into consideration the applicant's preferences, the institution should negotiate with the applicant the following conditions: loan and installment amounts, loan term, and repayment frequency. This section provides guidelines for setting these conditions.

1. LOAN AND INSTALLMENT AMOUNTS

The appropriate loan and installment amounts depend on two primary factors—the loan amount the client's enterprise can abosorb and the installment amount the household can afford.

The maximum loan amount depends on the applicant's *debt capacity*. The most important indicator of debt capacity is an applicant's current working capital.[2] The institution should only provide capital that the client's enterprise can absorb and use efficiently. In addition, the institution should not invest significantly more into the enterprise than the applicant has committed. An institution may decide, for example, that for trade and manufacturing businesses, first loans cannot exceed **150 percent** of working capital, and for service businesses, **200 percent**. The benchmark ratio for service businesses is higher because they often have very little working capital. The institution should set limits for each type of industry or business.

$$\frac{\text{Recommended loan amount}}{\text{Working capital}}$$

Take care that loans are not:
- Larger than what the applicant requested—never lend more than the amount desired by the applicant.
- Inappropriately small—if the borrower has the capacity to make use of a much larger loan, the borrower may seek additional loans from one or more other lenders, thereby weakening the original provider's relationship with and understanding of the borrower's financial condition, and potentially leading to over-indebtedness.

The household surplus is the best measure of the applicant's capacity to repay.[3] The monthly installment should not exceed a certain

2. Working capital is equal to current assets minus current liabilities. See Annex D. **Model business and household balance sheet**, line 9.
3. **Household surplus** can be defined as the amount of money remaining from all income sources, after regular and expected business and household expenses have been paid. Collection of data to determine household surplus is discussed on page 6. See **Annex C. Model household income statement** for a sample analysis of a household income statement to determine household surplus.

proportion of the total monthly household surplus (ratio at right). The benchmark maximum for this ratio is typically **between 50 and 80 percent.**

Applicants should not be required to use their entire household surplus to pay for a loan, because:
- Unexpected fluctuations in income may reduce the household surplus;
- Unexpected expenditures that were not taken into account during the evaluation may arise; and
- The information collected from the applicant is an estimation.

The institution must verify whether the applicant's household surplus will be sufficient to repay the recommended installment over the term of the loan. If the household surplus is likely to be insufficient at some point in time, the institution should adjust[4] the maximum installment accordingly.

The benchmark used for the household surplus ratio generally increases for renewal loans, depending on the number of loans the client has with the institution and the client's repayment history. For example, an institution may determine that for the first loan this ratio must not exceed **60 percent,** for the second loan **70 percent,** and for all subsequent loans, **80 percent.**[5]

2. LOAN TERM & REPAYMENT FREQUENCY
The optimum **loan term** depends on the seasonality of the business's sales. Ideally, the last installment of a loan falls in the month prior to the beginning of a period of high sales.[6] During that month the applicant will probably need new funds to purchase additional merchandise to cover the period of high demand (for example, the Christmas holidays or the beginning of the school year).

The optimum **repayment frequency** depends on the pattern of sales during the week and the month. Loan officers must check whether a weekly, fortnightly or

$$\frac{\text{Recommended installment}}{\text{Household surplus}}$$

> **Box 5. Loan Size Adjustments for Overheated Markets**
> BE CONSERVATIVE
> MFIs operating in overheated markets must adjust loan amounts to reflect the increased risk of client over-indebtedness. Overheated markets are those with a high concentration of institutions per capita, and those in which institutions are consistently over-lending. Careful analysis of existing debt is especially important during these market conditions, and institutions should consider that clients may not disclose all existing debt. If a loan is approved, consider offering clients a voluntary "cooling off period" during which the borrower can decide to cancel the loan after the contract has been signed.
>
> DEFINE "OVER-INDEBTEDNESS"
> Consider developing a qualitative definition of "over-indebtedness" to help staff determine which of the applicant's non-financial attributes may be risks for over-indebtedness. Use, for example: *A state in which a borrower has to make significant sacrifices to his or her standard of living or business affairs in order to repay debts.*
>
> USE A BENCHMARK
> Do not make loans to clients who already have too much debt. Early industry data suggest the following benchmarks:
> - Applicant has 1-2 existing loans = Low risk for over-indebtedness
> - Applicant has 3 existing loans = High risk for over-indebtedness
> - Applicant has > 3 existing loans = Very high risk for over-indebtedness

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4. See **Annex G. Sample criteria for adapting loan terms** for an example of an adjustment to installment amount based on client risk factors.
5. See **Annex G. Sample criteria for adapting loan terms** for an example of an adjustment to loan amount.
6. See **Annex E. Business Seasonality Worksheet.**

monthly repayment schedule would best fit the applicant's cash flow. For example, if an applicant operates on a two-week cycle, it may be difficult to save money for loan repayment until the end of the month. Fortnightly payments might be easier and therefore more secure.

Ideally, the repayment of the loan is scheduled for a day of high cash flow. Applicants may earn most of their income on a certain day in the week, for example on Saturdays, or at the end of the month, when salaried people make their purchases.

Requiring small, regular payments is the most convenient way to encourage borrower discipline and monitor performance. However, consideration should also be given to the needs of clients with seasonal cash flows, such as farmers, or those who have borrowed to buy equipment that can only be used effectively after a certain investment of time. Large bullet and balloon payments should be avoided because they put a burden on the client to accumulate a large sum of money, and clients may borrow from other sources to pay the loan. Prepayment penalties are also generally discouraged, as they can reduce a client's ability to use loans for productive financial management.

3. CHECK COLLATERAL

Collateral information[7] gathered during the data collection process forms just one part of the decision to approve or reject a loan. Data from the field reveal a wide range in policies about collateral, but for institutions that take collateral, usually between **40% and 80%** of the loan is covered through some form of collateral.[8]

$$\frac{\text{Value of collateral}}{\text{Loan amount}}$$

Though an institution should secure itself against potential losses, it should not depend on collateral for loan repayment. Excessive over-collateralization can create hardships for clients if the collateral is liquidated. Careful consideration should also be given to the results of liquidating collateral that is critical to the borrower's livelihood or home.
Collateral should be important enough to the borrower that she/he does not want to lose it. However, removing a source of livelihood, such as a piece of equipment, can exacerbate a borrower's debt problems. Clear guidelines for what constitutes acceptable collateral are essential for credit staff to protect clients during the formulation of the loan proposal.

4. ADJUSTMENT FOR BACKGROUND INFORMATION AND CHARACTER INFORMATION

The institution should adjust the above terms—installment and loan amount, loan term, and repayment frequency—based on the applicant's risk profile. The institution should apply the client's non-financial data to the loan decision at this point (**review Section II B. Non-financial Analysis**, page 10, for guidelines on which of these indicators to collect and how to evaluate them). Institutions should train credit staff on how to evaluate qualitative information appropriately, and how to apply it to an applicant's overall risk profile.

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7. See **Annex F. Questions for collecting collateral information**.
8. See **Annex G. Sample criteria for adapting loan terms** for an example of an adjustment to collateral amount.

CONTENT IN REVIEW

"Avoidance of Over-indebtedness: Guidelines for Financial and Non-financial Evaluation" is a complement to the "Smart Lending: Client Protection in the Client Process" tool, which was released in 2010, and which provides broad guidelines for how institutions can incorporate good practices in client protection throughout all of their lending processes and policies. In contrast, the "Avoiding Client Over-indebtedness" tool focuses on just three points in the process — collection of non-financial data, collection of financial data, and approval — delving deeply into recommended practices for each.

Institutions should take full advantage of the information provided by both financial and non-financial data to mitigate the risk of client over-indebtedness. Analyzing non-financial data in particular can reveal warning signs of an applicant's predisposition not to repay, while both types of data can help the institution to match each client with the product, loan size, term, and collateral requirements most suitable to the client's capacity to repay.

The collection and evaluation of financial and non-financial data involves two main steps: 1) using all available third-party data sources to research the applicant's background, and 2) collecting and analyzing information from the loan applicant him/herself. In the first step, available third-party databases can include those maintained by credit bureaus, national networks, and the institution's own records of past interactions with the client. It is also advisable to verify the existence of home, business, and suppliers, as well as to speak with client's references (e.g., home and business neighbors, guarantors).

At the conclusion of this step, the institution may already have reason to deny certain applications. For the remaining clients, the institution will proceed to the second step, often achieved through a home and/or business visit. Non-financial data will help establish the client's character, management capacity, and family situation, and at minimum should include an investigation of both the applicant's business situation (e.g., experience, business stability, intended loan use) and his or her family situation (e.g., personal and household characteristics). Financial data collection will focus on the income, expenditures, assets, and liabilities of the applicant's business and family, and should include a household income statement, a household balance sheet, an assessment of the seasonality of the business, and an investigation of available collateral.

Upon completing data collection, the institutions must carefully evaluate client creditworthiness and debt capacity. There are three steps to this process: financial and ratio analysis, non-financial analysis, and development of the loan proposal. The financial ratios provide key data points in areas like profitability of the client's various revenue sources, amount of client's available working capital, level of indebtedness, and liquidity, all of which help determine the client's capacity to repay. Non-financial data, notably the history of the business, how carefully the client keeps records, and how open the client is in providing you with requested business and household data, are also critically important, as the applicant's character and attitude toward the loan application and repayment processes provide insight into the client's future willingness to repay.

Once the institution makes a decision to approve a loan, several important considerations are involved in the formulation of the loan proposal. In particular, the institution should negotiate with the applicant the following conditions: loan and installment amount, loan term, and

repayment frequency. All terms and conditions should reflect the data the institution has gathered about the client, with the amount of the loan neither exceeding the quantity of funding that the applicant's business can absorb, nor being too small for the client to achieve his or her investment plan. The loan term and repayment frequency should reflect the seasonality and pattern of the client's business. Finally, institutions should be more conservative in overheated markets, acknowledging the greater risk that clients will become over-indebted.

Throughout the entire client data collection process, institutions should be sure to follow their own Code of Ethics when interacting with loan applicants. Transparency about the policies of the institution, and procedures it follows, and the terms of its products, is also paramount. Clients should know why each of piece of data was collected and how it will be used, as well as have complete understanding of the terms of the credit products offered, so that they can make informed financial decisions.

ANNEX A. SAMPLE NON-FINANCIAL BUSINESS QUESTIONS

Part 1. Indicators of experience, stability, and organization

1.	Years in existing business	☐ < 1	☐ > 1	
2.	Ownership of business premises	☐ owned	☐ rented	
3.	Years in existing premises	☐ < 1	☐ > 1	☐ > 5
4a.	Existence of business records	☐ yes	☐ no	
4b.	Type of business records	☐ sales	☐ purchases	
		☐ payables	☐ receivables	☐ stock

Part 2. Indicators of commitment to the business

5a.	Months a year business operates	☐ > 11	☐ < 11
5b.	Days a week business operates	☐ < 5	☐ > 5
5c.	Hours a week owner is in business	☐ < 32	☐ > 32
6a.	Business is in a secure location	☐ yes	☐ no
6b.	Business is visible and accessible	☐ yes	☐ no
7a.	Security measures have been taken	☐ yes	☐ no
7b.	Business looks clean and attractive	☐ yes	☐ no
7c.	Owner has invested in business	☐ yes	☐ no
7d.	Owner has made improvements over year	☐ yes	☐ no

Part 3. Indicators of business size, responsibility for loan and intended loan use

8.	Number of customers	☐ < 3	☐ > 3	
9a.	Number of employees working in business	☐ none	☐ 1-5	☐ >5
9b.	Number of relatives working in business	☐ none	☐ 1-5	☐ >5
9c.	Type of workers	☐ occasional	☐ temporary	☐ permanent
9d.	Responsibility for daily operations	☐ owner	☐ relative	☐ employee
9e.	Responsibility for purchases	☐ owner	☐ relative	☐ employee
9f.	Responsibility for closure	☐ owner	☐ relative	☐ employee

10a.   Person running business in absence of owner _____
☐ relative   ☐ employee   ☐ other

10b.   Person assisting in payment if business fails   _____
☐ relative   ☐ non-relative

11.   Intended loan use   _____

ANNEX B. SAMPLE NON-FINANCIAL FAMILY QUESTIONS

Part 1. Characteristics of the family and household

1.	Date of birth and age	_____	
2.	Civil status	_____	
3.	Level of education	_____	
4a.	Applicant lives in own home	☐ yes	☐ no
4b.	Applicant makes mortgage payments	☐ yes	☐ no
4c.	Applicant pays rent	☐ yes	☐ no

4.	Number of household members	_____
5.	Number of dependents	_____
6.	Household members and dependents in school	_____
7.	Household members and dependents who are ill	_____

Part 2. Personal characteristics

8a.	Level of organization	☐ high	☐ medium	☐ low
8b.	Level of dynamism	☐ high	☐ medium	☐ low
8c.	Level of discipline	☐ high	☐ medium	☐ low
8d.	Punctuality	☐ high	☐ medium	☐ low
8e.	Openness	☐ high	☐ medium	☐ low
9a.	Partner agrees with loan application	☐ yes	☐ no	☐ n.a.

9b.	Signature of partner	_____

ANNEX C. MODEL BUSINESS AND HOUSEHOLD INCOME STATEMENT

Model Business and Household Income Statement		
1	Sales	
2	Cost of goods sold	
3	**Gross Profit (1 - 2)**	
4	**Operating Expenses**	
4.1	Salaries	
4.2	Utilities (water, electricity, gas, etc.)	
4.3	Fixed and mobile telephone	
4.4	Transport	
4.5	Rent of the business premises	
4.6	Taxes (dues, licences, customs, etc.)	
4.7	Construction and maintenance	
4.8	Loan repayments	
4.9	Other operating expenses	
5	**Net Profit (3 - 4)**	
6	**Other Household Income**	
6.1	Salaries from employment	
6.2	Rental of property	
6.3	Pensions	
6.4	Net surpluses from other businesses	
6.5	Remittances	
6.6	Other family income	
7	**Total Income (5 + 6)**	
8	**Household Expenses**	
8.1	Food & Toiletries	
8.2	Housing	
8.3	Utilities (water, electricity, gas, etc.)	
8.5	Fixed and mobile telephone	
8.6	Transport	
8.7	Education	
8.8	Health	
8.9	Construction and maintenance	
8.10	Loan repayments	
8.11	Other family expenses	
9.	**Household Surplus (7 - 8)**	

ANNEX D. MODEL BUSINESS AND HOUSEHOLD BALANCE SHEET

Model Business and Household Balance Sheet	
1	**Current Business Assets**
1.1	Cash
1.2	Bank
1.3	Accounts receivable
1.4	Stock
2	**Fixed Business Assets**
3	**Other Business Assets**
4	**Total Business Assets (1 + 2 + 3)**
5	Current Business Liabilities
5.1	Accounts payable
5.2	Advance payments
5.3	Short-term loan payments
6	**Long-term Business Liabilities**
7	**Other Business Liabilities**
8	**Total Business Liabilities (5 + 6 + 7)**
9	**Business Capital (4 − 8)**
10	**Total Business Liabilities & Capital (8 + 9)**
11	**Family Assets**
12	**Family Liabilities**

ANNEX E. BUSINESS SEASONALITY WORKSHEET

Business Seasonality Analysis													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	Total value of sales
High													
Medium													
Low													

Use the business seasonality analysis as a method to calculate the optimum loan term. **Loan officers should take the following steps:**

1. Start by asking whether this month's sales were high, medium or low compared to the other months of the year. Tick the appropriate box in the month's column.
2. Tick the boxes in the other monthly columns according to whether sales were high, medium or low in those months.
3. Ask for total sales values for months with high, medium, and low sales over the past year.

EXAMPLE

Business Seasonality Analysis													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	Total value of sales
High	X									X	X	X	**22,000**
Medium		X		X	X				X				**20,000**
Low			X			X	X	X					**17,000**

ANNEX F. QUESTIONS FOR COLLECTING COLLATERAL INFORMATION

COLLATERAL INFORMATION FORM

1. Describe type of collateral available from client:

_____
_____
_____
_____

2. Describe type of collateral available from guarantor:

_____
_____
_____
_____

3.   Enter detailed information on the collateral below:

#	Description (item, type, serial #, etc.)	Location (business or home)	Date of purchase	Purchasing value	Estimated current value

ANNEX G. SAMPLE CRITERIA FOR ADAPTING LOAN TERMS

Proposed monthly installment Household surplus				**Loan amount** Working capital			
Credit	1st	2nd	3rd& more	Credit	1st	2nd	3rd& more
Low Risk	< 60%	< 70%	< 80%	Low Risk	< 70%	< 80%	< 90%
Medium Risk	60%-70%	70%-80%	80%-90%	Medium Risk	70%-80%	80%-90%	90%-125%
High Risk	> 70%	> 80%	> 90%	High Risk	> 80%	> 90%	> 125%
Total liabilities + loan amount Total assets				**Net present value of collateral** Loan amount			
Credit	1st	2nd	3rd& more	Credit	1st	2nd	3rd& more
Low Risk	< 60%	< 70%	< 80%	Minimum Coverage	150%	125%	100%
Medium Risk	60%-70%	70%-80%	80%-90%				