MicroSave Briefing Note # 86

Product Features of Individual Lending (1/2)

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The majority of microfinance institutions (MFIs) have mastered lending small amounts to people, who would otherwise turn to high-charging money lenders, using group-based systems. Recently MFIs have been attempting to reach slightly better-off people using individual lending (IL). It is very important for an MFI to start the product development process with market research[1] to understand the clients' needs and preferences and create a client responsive product offering. This note covers the most common product features to be considered for IL.

Loan Size

Loan size is a key differentiator between individual and group lending. Most MFIs offer IL loan amounts ranging from $400 to $1,000/$1,500, but some offer loan amounts as high as $7,000. MFIs implementing IL need excellent credit appraisal mechanisms, especially for relatively large amounts (>$1,000). They also need entirely separate staff dedicated to assessing IL issues like detailed business and household cash flow analysis, sector/market knowledge and client business monitoring. Group-based lending requires credit officers who are not required to assess or appraise borrowers – but simply to issue and collect loans. Conversely, IL requires a level of business analytics that few group lending credit officers possess.

Some MFIs in the Philippines and in India extend IL amounts as low as $100-$200 – these are likely to be below the threshold necessary to generate sufficient earnings to meet the direct operational costs per loan. MFIs should not try to cross subsidise earnings from larger loans to service smaller loans. It is recommended that MFIs conduct detailed product costing as part of the pilot-test, to determine product delivery costs, and the pricing is and refined prior to rollout. [2]

There are MFIs in the Philippines and Africa which offer $600-$1,000 (and >$3,000 in few cases) under group lending methodology. These MFIs then have the tendency to migrate graduate clients from group to individual lending with higher initial amounts not supported by business cash flow assessment. This can result in under- or over-funding and increased risk of delinquency. IL approval should always be based on the 5Cs (Character, Capital, Conditions, Capacity, Collateral) and 3 Ms (Money, Market and Management) analysis rather than calculating it based on the previous loan amount.

> A commercial bank in East Africa failed to respond to its clients' growing need for higher loans through IL, even in the face of mounting client drop outs to competitors offering the product. Instead, group loan size ceiling was raised to levels that rendered the group guarantee ineffective and resulted in runaway delinquency. A few clients were then incentivised to pay up by being migrated with high initial loan amounts to an poorly designed IL product devoid of a proper business assessment methodology, even when this could have been easily replicated (and even improved upon) from competitors. The result? High default for both group based and individual loans!

Loan Term

Another key differentiator between group lending and IL is loan term flexibility. Most MFIs offer IL loan terms varying from 3 to 18 months, a few offer longer terms up to 2 or 3 years usually for repeat loans. MFIs in Africa, Philippines and a few in India offer such extended loan terms. Tailored terms for clients are helpful to clients and MFIs as:

- Clients who have seasonal business cash inflows can pay back lump sums during the peak period and avoid the need to take emergency consumption loans during lean periods.
- It lowers the chances of delayed or prepayments by clients and hence allows the MFI to better plan their cash flows.

Repayment Frequency

Generally, IL is offered with monthly repayment, but there are some notable exceptions. For instance, in India, Bandhan and Maarg[3] are successfully offering weekly repayment for IL. The frequency of repayment should depend on the client's cash flow and business cycle, as well as the MFI's needs and comfort level.

Most MFIs offer a rigid repayment structure (Equated Monthly Instalment - EMI/EFI/EWI), which in most contexts ignores both the general business cycle and seasonality of clients' businesses. As a result, clients can face repayment problems during periods when they have low cash inflow. A number of MFIs in East Africa try to mitigate this by requiring that the client's household should have an additional source of income to meet small

[1] See *MicroSave* Toolkit on "Market Research for MicroFinance" and Briefing Note # 84 "Individual Lending for MFIs–Strategic Issues to Consider First"

[2] See *MicroSave* Toolkit on "Costing and Pricing of Financial Services" for how to conduct allocation based product costing

[3] Maarg (offering exclusively individual loans) is a division of Grameen Financial Services Pvt. Ltd, an MFI based in India

token payments during such periods. The challenge is that few MIS (or indeed regulatory requirements on portfolio reporting) can accommodate non-fixed repayment patterns, and the risk of not detecting and addressing impending default in a timely manner is higher.

Though rare, one can find models, such as *SafeSave* in Bangladesh (www.safesave.org), which has loans with no fixed terms and no fixed repayment schedules (only interest payments are required). Most banks offer similar services to trade clients, often in the form of working capital demand loans or lines of credit.

Moratorium (or Grace Period)
In IL, often the fixed repayment period does not begin immediately, i.e. a repayment moratorium or grace period is allowed. Generally, MFIs provide moratorium periods ranging from 7- 45 days. This enables the client to use the loan amount in the business activity to generate loan repayment cash flows rather than repaying the first instalment from the loan amount itself or from other household cash inflows.

Prepayment
An option for prepayment can be offered to clients who genuinely want to repay the loan when they have a surplus. However, to control loan pre-closures aimed at obtaining higher loans, MFIs might want a policy requiring clients who have prepaid their loans to wait for the loan period, or most of it, to lapse before being considered for the next loan. Clients who want to match their loan renewal cycle with their business cycle can be excluded from the policy. To avail this facility, MFIs also usually charge the clients a fee for early pay-off. MFIs must carefully construct and monitor this provision as it can have a profound effect on cash flows and liquidity.

Purpose
The purpose of the loan should be restricted to business requirements like working capital, business expansion or business asset acquisition (such as refrigerator for a restaurant, small machinery for cloth manufacturers etc.). Loans for start-ups are not recommended as the risk of default is high due to the high failure rate of start-ups. MFIs should probably gradually extend the purposes for which loan can be availed over a period of time depending on their capacity and risk – starting with lower risk loans like working capital and then moving to asset acquisition (that require longer terms).

Collateral/Back-up
IL is perceived as a high risk lending methodology as it lacks a group guarantee. In IL, the group guarantee is often replaced with psychological or formal collateral. *MicroSave* has worked with MFIs using psychological collateral across Africa, in India and the Philippines. MFIs ask for a guarantor and collect un-dated or post-dated cheques (PDCs) from the client (and in a few cases PDCs from the guarantor too – a practice common in India).[4]

Many MFIs also insist on including the spouse of the applicant as a co-applicant or guarantor since they are more comfortable with lending to women than men, even though many of the enterprises targeted under this methodology are run by men. Where the spouse guarantees the loan, a few MFIs do not require a third party guarantee.

MFIs typically face a big challenge in serving clients with relatively large loan requirements due to clients' lack of tangible assets. Some MFIs take formal collateral, like asset mortgage, which eventually increases the cost to the client in form of valuation and mortgage/hypothecation fees. Moreover, this option is often not successful as MFIs often struggle to dispose of the collateral, as obtaining legal approval and auctioning the assets can be difficult. As a result, cases abound of MFI offices and warehouses filled up with repossessed assets like vehicles (motorcycles/bicycles etc.) and household assets.

MIS-led or Market-led Product?
Many MFIs have restricted IL product features to those that their MIS (often predominantly designed for group lending) can accommodate, rather than the innovative attributes required from an IL product. MFIs should always deliver an IL product that meets client needs, even if this means starting with a manual portfolio management system while seeking a robust MIS before lending reaches significant scale. Inappropriate product design encourages default.

Conclusion
The product development process should start with market research to understand the clients' needs and preferences rather than copying the product from other MFIs. Basic product features like loan size, term, repayment frequency, moratorium period, prepayment, purpose, and collateral need to be set after carefully considering the research results and the MFI's capabilities (but not limited to MIS compatibility). This note has covered the basic product features, while the next note, Briefing Note # 87, examines the other 'Ps' of Marketing: Price, Positioning, Process, Promotion, People, Place and Physical Evidence.

[4] MFIs need to be careful in dealing with un-dated PDCs as it has been observed that few MFIs obtain un-dated PDCs even without mentioning the name. The PDCs are purely blank cheque signed by the client/ guarantor, and this practice can lead to legal problems.