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INDIVIDUAL LENDING



OPTIMISING PERFORMANCE AND EFFICIENCY SERIES

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“STRENGTHENING THE CAPACITY OF
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OPTIMISING PERFORMANCE AND EFFICIENCY SERIES

INDIVIDUAL LENDING

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INDIVIDUAL LENDING: THE NEED, APPROACH AND CHALLENGES



Group-based lending is most prevalent amongst MFIs targeting the poorer sections of the community. It allows MFIs to reduce transaction costs and, at least in the initial loan cycles, reduce risk through joint-liability and guarantee arrangements within the groups. However, the effectiveness of group-based guarantee decreases as the groups mature and the members take varying loan sizes. Across the globe increasing numbers of MFIs are offering long-term clients individual loans once they graduate from group-based systems. Grameen Bank and ASA, in Bangladesh, began with group lending but no longer enforce group guarantees. A growing number of MFIs, including both Grameen and ASA offer both group and individual loans to their target market.

Individual lending methods are typically used for slightly larger loan sizes than the group-based approach. These larger loans make it cost effective for MFI staff to visit and conduct a rigorous assessment of the client's business and its cash flow. Another difference is that individual loans often require closer and more frequent monitoring such as monthly site visits or calls. Whereas group lending has a group guarantee, individual loans may only require one or two guarantors or, in many cases, pledged collateral.

“We have a carefully selected mix of loan products to meet the needs of our broad customer base. We offer business loans to small enterprises, salary loans to the low income employed, and an individual cashflow based product for the micro-entrepreneurs. We also offer specially tailored loans for agriculture. We introduced the Biashara Imara, cashflow-based product for the microentrepreneurs when we realised this represented a huge and completely un-served market in Kenya” – James Mwangi, Equity Bank, Kenya.

Microfinance originated to cater to the financial needs of the un- or under-banked low and middle income segments of the population. While it began with a vision to serve poor holistically, it soon became largely focused on group lending products. MFIs traditionally stuck to this mono-product approach to reduce the cost of operations and to scale-up rapidly. However, as clients matured and began to demand customised products, individual lending's raise to prominence became inevitable. Individual lending (IL) is often an MFI's first effort to provide market-led products to their client base. And improve client retention. Individual lending provides a competitive edge to MFIs operating in competitive environments, where several sellers are offering almost substitutable products (largely group based loans) at similar prices.

Thus client-focussed MFIs often offer individual lending to provide extra services in response to the demands from their higher value clients, and to better serve mature clients who have increased their repayment capacity and need larger loans. These clients' have often outgrown group lending: they require extra cash, are not able to attend group meetings and have cashflows that require monthly rather than weekly repayments.

Individual lending creates challenges for MFIs including the need for flexibility in product design, skilled loan officers, customer oriented branches. However, implementing individual lending potentially opens a whole new market of unserved borrowers – the “missing middle”. Well-designed individual lending programmes allow institutions to tap new markets, improve services and compete more effectively by offering customised products. In turn, this also helps the microfinance institutions to diversify their portfolio risk and cross-sell other products such as insurance, investment and savings to these valued clients, further increasing client stickiness.

Most MFIs have started to realise the importance of introducing individual lending, however because it requires a paradigm shift many MFIs struggle to initiate IL programmes. Thus individual lending is

in its infancy in many markets worldwide, and institutions are still learning to cope with the challenges and risks of operationalising this product. Some significant issues in introducing individual lending are: increased information asymmetry; absence of group-based guarantees; comparatively higher-value loans; and the resulting higher credit risk. Individual lending requires different processes and systems such as: sophisticated and flexible MIS to gather and analyse client information; and highly skilled staff with ability to conduct detailed due-diligence (to assess the market, management, suppliers, customers of the business to be financed) and prepare realistic cash flow analyses and assess collateral.

MicroSave's experience has shown that there are many challenges in introducing individual lending, including:

- ***Design of product based on market research*** – Individual lending by its very nature is a customised product and cannot be structured like group loans with fixed loan amounts and incremental increases in each subsequent cycles. A predetermined structured approach is likely to lead to underlending to some clients, thus, defeating the purpose of such loans.
- ***Cash-flow based lending*** – Unlike group lending, loan decisions for individual lending clients are tailored according to the specific individual needs of each applicant, supported by the detailed assessment of clients' financial situation based on data gathered/analysed by loan officers. The process usually involves assessing client's individual and household cash flows and deciding the loan amount accordingly.
- ***Asset backed lending*** – Such form of lending requires clear legal documents establishing ownership of an asset to the borrower. However, mostly these assets are jointly owned by the family members and many legal environments make it extremely difficult to realise collateral. Thus, MFIs providing loans against collateral can face a host of issues around repossessing and disposing of these assets.
- ***Adequate MIS capacity*** – A robust MIS is essential for an IL product – particularly if flexible repayments are to be accepted to reflect the borrower's business cycle. Most of the MIS applications being used by MFIs are designed to handle standardised products, and lack scope for customisation to suit the needs of IL.
- ***Recruiting/training competent staff*** – IL staff are required to assess and evaluate businesses, identify the credit needs and structure loans accordingly. This requires them to be significantly more qualified than their group-based lending counterparts. These skills have to be transferred through intensive training and experienced staff.
- ***Staff incentives for IL staff*** – Microfinance institutions offering both group and individual loans often face challenges in designing staff incentive schemes to avoid conflicts of interest among these two groups arising from group lending credit officers reluctant to graduate their good group-based clients into the IL programme.
- ***Liquidity to manage the demand for individual loans*** – Because loan sizes are much larger, IL can place considerable strain on an MFI's cashflows. Thus, MFIs might face challenges of arranging enough capital, as well as adequate liquidity management systems to offer the product.
- ***Branch based transactions and relationship management*** – IL typically requires more sophisticated infrastructure than group lending, and is likely to entail revamped branches for increased in-branch customer service, This also necessarily means a significant increase in costs.

MicroSave has been working with MFIs across their operational areas and supporting institutions to offer IL products to their clients, thereby facilitating market-led solutions towards true financial

inclusion. *MicroSave* has worked with institutions like Drishtee, Grameen Koota, Arohan, KGFS, Sonata, Svasti Microfinance, Fullerton India, Spandana and Sharda in India; TSPI, ASKI and OK Bank in the Philippines; Equity Bank in Kenya and Finance Trust in Uganda in helping them develop or overhaul their IL product while aligning to their customer needs and requirements.

MicroSave has conducted strategic planning and pilot-testing with MFIs to understand needs and assess the readiness of both MFIs and their customers. In addition to this, *MicroSave* has been involved in all stages of IL product development and operationisation including market research for IL product development, product development, pilot testing, pilot test reviews, product roll-out for new IL products and product re-engineering for exiting IL products.

This booklet brings together a set of brief publications which extract key lessons from *MicroSave*'s rich expertise and experience, combining these with the views and opinions of leading practitioners.

1. *Individual Lending for MFIs – Strategic Issues to Consider First*
Krishna Thacker and Trevor Mugwang'a

This note highlights the key strategic issues that need to be on the top priority of the management of an MFI venturing into individual lending. These include the institution's mission, industry and competitive environment, IL client segmentation and institution's capacity to deliver the product.

2. *Managing Individual Lending*
Denny George, Venkata N. A. and Trevor Mugwang'a

This note discusses how MFIs using group lending methodology have started to offer individual lending to their clients – and the challenges they have faced. As IL is a completely different product, it requires very different skill sets and customised processes and operations. This note highlights important issues for optimising individual lending.

3. *Product Features of Individual Lending – Part 1*
Venkata N. A. and Trevor Mugwang'a

This note highlights the key product features on which an MFI must focus before offering individual loan products to the clients. These features include loan size, loan term, repayment frequency and pre-closure rules. Market research is a pre-requisite for launching a successful new product offering and MFIs must carefully dwell upon important product features of individual loan before rolling out the product.

4. *Product Features of Individual Lending – Part 2*
Venkata N. A. and Trevor Mugwang'a

This note discusses seven of the 8Ps of marketing - price, positioning, process, promotion, people, place and physical evidence with respect to individual lending products. MFIs should finalise the product features based on their strategy and competitive positioning in the market, but should always be aware that offering individual loans is very different from delivering group-based loans.

5. *Breaking the Barriers: Market Expansion through Individual Lending*

Venkata N.A., Anup Singh and Trevor Mugwang'a

This note discusses the benefits of IL, the target clientele and challenges MFIs need to consider in developing the product. It further explains how IL can help retain group-loan clients, help MFIs foray into new market segments for expansion, increase portfolio size and profitability and also reduce portfolio concentration risk.

6. *Challenges of Introducing IL in India*

Anup Singh and K. Somanadha Babu

This note discusses some of the key challenges faced by MFIs implementing individual lending model in India. These challenges relate to coping with cash-flow based lending, operation and human resource issues, financial management and establishing effective MIS to integrate the needs of graduating clients and also open new market segments.

7. *Risks and Challenges in Individual Lending*

Sandeep Panikkal, Venkata N.A. and T.V.S. Ravi Kumar

This note examines the risks associated with individual lending and makes recommendations for MFIs considering starting an IL programme. Many Indian MFIs introduced the IL methodology as a natural progression from the group lending methodology. However, IL has its own idiosyncratic requirements like cash flow based lending; analysing business needs and risks; bringing flexibility in product features; building staff capacities and processes that must be followed for successful implementation.

8. *Developing Cash Flow Based Individual Business Loans: The Experience of Equity Bank with Biashara Imara*

Trevor Mugwang'a

This note highlights key lessons from the experience of *MicroSave's* partner Equity Bank, in designing, testing and rolling out a cash flow based individual business loan product. It analyses why Equity ventured into cash flow based micro credit noting that it was driven by a realisation that there was a substantial, and largely unmet, demand for this type of product. The note further highlights the key lessons learned during the pilot testing process.

9. *Microfinance Institutions and Salary Based Consumer Lending*

Trevor Mugwang'a and David Cracknell

This note draws on the experience of *MicroSave's* Action Research Partners (ARPs), involved in providing consumer loans to low income salaried workers. It cautions institutions intending to provide such loans that demand for these loans can outstrip available funds very quickly. It also suggests managing risks and explains the strategies such as using pilot tests to identify operational constraints, managing employer-employee relationships, controlling repayments, ensuring affordable loans to customers, strengthening credit control and administration, and using technology for further reducing the risks.

10. Why do Microfinance Clients Take Multiple Loans?

Veena Yamini A. and Venkata N.A.

This note presents the rationale and impact for multiple borrowings from a client perspective and discusses how the MFI and its leaders perceive the issue and its implications. MFIs can reduce the incidence of multiple borrowing. The appropriateness of disbursement timing can be improved through studying microenterprise cash flows by type, and changing operational policies to reduce mismatches between client cash flows and the timing of loan cycles.

11. Are Loan Utilisation Checks Really Necessary?

Graham A.N. Wright

This note questions the necessity of loan utilisation checks in microfinance service delivery in group based systems. However, the note also maintains that loan utilisation checks are extremely important for larger individual, enterprise development loans due to its large loan size and sanctioned on the basis of the credit officers' assessment of the cash flow of that particular business.

12. Market Strategy Development and 3rd Generation Microfinance in India

Anant Jayant Natu

This note highlights the inadequacy of “product-centric” approach of the first and the second generation microfinance (SHG-Bank linkage and the MFI led JLG model respectively) to face up the challenges posed by the fierce competition resulting from a glut in microfinance service providers in certain regions. It also talks about the emergence of 3rd generation microfinance in India.

INDIVIDUAL LENDING FOR MFIs – STRATEGIC ISSUES TO CONSIDER FIRST

Krishna Thacker and Trevor Mugwang'a



BACKGROUND

For more than a decade, *MicroSave* has been working with microfinance institutions (MFIs) to develop individual lending (IL) products. This note discusses some of the major strategic considerations, and their implications, which every MFI ought to take into account before designing an IL product.¹ These issues/strategies should ideally be factored into the MFI's strategic planning², and also need to be carefully considered before beginning market research.

Strategic considerations include: a) institutional mission, vision and objectives; b) the industry and competitive environment; c) IL client segments; and d) institutional capacity to deliver IL.

INSTITUTIONAL MISSION AND VISION

The foremost consideration is whether the target markets for the new IL product fit with the MFI's vision, mission and objectives. Institutional mission focussed on a particular level of client income level, gender, or nature of locations may preclude, or limit, IL.

THE INDUSTRY AND COMPETITIVE ENVIRONMENT

As with all products, the MFI should study the market in which it operates and analyse all factors which are likely to influence the success of IL in the present and future. This includes the legal and regulatory conditions (for pricing and contractual enforcement implications); the state of the MFI's technology; the MFI's competitors; the potential IL clients the MFI is currently serving; the health of current IL loan portfolios in the market; the depth of service provision in the target market and the cultural norms in the area.

CHOOSING ONE OR MORE IL CLIENT SEGMENTS

An MFI may move from its current product and clients to offering current products to new client base, or developing a new product for an existing or new client base. These options and associated nature of risks are depicted in the Product-Market Risk figure below.

A new product and new client base is the most risky strategy in the short-term because the MFI has no operating history and familiarity with both the new product and the new client segment. Introducing IL often places an MFI in one, or both, of the top two quadrants on a basic Ansoff matrix (see diagram):

- New market segment, e.g. clients with a higher income level, men (due to higher income levels and/or preference for individual access); or
- Existing market segment, e.g. graduating group lending clients; or
- A mix of new clients and existing clients.

Product-Market Risk Framework*		
Market Product	Existing Client Base	New Client Base
New Product	Product Risk	Both Market and Product Risk
Existing Product	MFI Comfort Zone	Market Risk
Risk Trajectory		

¹See *MicroSave* Briefing Notes # 86 and # 87 on "Product Features of Individual Lending".

²See *MicroSave* Toolkit on "Strategic Business Planning for MFIs".

NEW CLIENT SEGMENT

Many MFIs begin by lending primarily women, perhaps because of their mission and women's higher comfort level with group lending, or women's proven better repayment track record. However, men are more likely to be involved in running enterprises with larger financing needs - so MFIs introducing cash flow-based IL will need to consider adding them. Overall experience suggests that unlike group lending, with IL MFIs need to focus more on the cash flow of an entire household and often need to have a spouse as a co-applicant/ guarantor. It is easier for men than women to enjoin their spouses and households in repayment liability for IL. In the long-run, the clientele should be a mix of both men and women, with a primary focus on the ability to run an enterprise with a relatively high financing need.

EXISTING CLIENTS

Migrating existing clients to IL is often a quicker and more cost-effective approach to start IL operations than taking on new clients. This approach can also result in lower credit and product risk as the clients have built a repayment history with the MFI, and may be more willing to accommodate product feature or process related glitches in the first months. However in the long-term, this approach is likely to result in lower than expected growth of the product. Offering a new product to existing clients can create cannibalisation in which existing clients abandon their current group-based lending product, also resulting in lower overall growth. Unless it is the MFI's intention to phase out other products, the IL product should be carefully designed to prevent cannibalisation.

MIXING EXISTING AND NEW CLIENTS—BEST OF BOTH WORLDS?

A mix of existing and new clients may sound like a “best of both worlds” idea, but the MFI should conduct regular reviews to ensure that both segments are content with the product, and that risks are not unduly concentrated in one segment.

INSTITUTIONAL CAPACITY

An MFI's culture, structures, systems, and processes (branch infrastructure, MIS, institutional culture etc) are often specifically geared towards serving a specific client segment. The decision to move beyond group lending to a fundamentally different (IL) market segment typically necessitates significant institutional changes with considerable investment in both time and financial resources.

INFRASTRUCTURE / MIS

IL typically requires more sophisticated infrastructure than group lending, and is likely to entail revamped branches for increased in-branch customer service, as well as more robust/automated systems for client record keeping, reporting and internal control. Some experienced lenders are even attempting to build credit scoring systems over time to improve the efficiency of credit appraisal - though this has proved challenging.

MANAGEMENT AND STAFF COMPETENCIES³

Additional technical competencies typically required for the introduction of IL include enhanced overall credit management, credit appraisal and monitoring skills, customer service, a staff incentive scheme and a legal enforcement function. Considerable capacity building assistance sourced externally is often necessary.

³See *MicroSave* Briefing Note # 87 “Product Features of Individual Lending Part-2” .

Liquidity: Because loan sizes are so much larger, IL can place considerable strain on an MFI's cash flows. Consideration should be given to whether MFI has enough capital, as well as adequate liquidity management systems to offer the product.

A WORD ON ASSET FINANCING⁴

Overall repayment trends suggest that cash-flow based business loans for working capital and loans backed by liquid assets, like gold, perform better by comparison to loans for asset acquisition (e.g. motorcycles, auto rickshaws, etc). MFIs providing loans for asset acquisition can face a host of issues around repossessing and disposing of the assets. Although the risk profile of these loans can be higher, with appropriate processes and systems, the right pricing and a strong risk appetite, they can help an MFI open up a completely new market and increase its profitability. However, these types of loans may simply not be the right choice when first venturing into individual lending.

ASSET FINANCING: HARD LESSONS FROM PRACTICAL EXPERIENCE

An urban MFI in western India started a loan product for purchase of vehicles. As per the process, a loan would be provided to purchase auto-rickshaws, which would be hypothecated to the MFI. The repayment in the initial phase seemed quite regular, but after an initial period of around one year, the warehouse of the MFI started to fill up with an alarmingly large stock of repossessed vehicles. The MFI found it increasingly difficult to manage these repossessed vehicles, and as a consequence, the losses associated with the product increased as well.

Another MFI in East Africa first ventured into IL with a micro-leasing product. Business assessment was weak, the MFI instead derived comfort in using the acquired assets as collateral for the loans. Unfortunately clients colluded with suppliers to inflate the cost of equipment acquired so that they could have the extra funds to divert to non-business use, others handed the financed assets back to the suppliers, who paid a discounted value. The result was considerable credit losses. The MFI had to stop the scheme and begin afresh with an IL working capital loan with well designed business appraisal methodology.

CONCLUSION

Environmental factors, the needs of target clients and the adequacy of institutional capacity are critical considerations for any product development team in introducing an IL product. Market assessment will determine the scope for the introduction of individual loan in the market, client based market research will establish client needs for the design of an appropriate product, and institutional development will enable the MFI to deliver the product.

As increasing numbers of MFIs introduce IL, lessons are being learnt (often, unnecessarily, the hard way) about the importance of the institutional infrastructure, type of staff and nature of the MIS, necessary to support effective individual lending. The challenges are plenty – but the rewards for the MFI and its clients, are very significant indeed.

⁴See *MicroSave* India Focus Note 14 “Challenges of Introducing IL in India” for more details on asset and cash flow-based financing.

MANAGING INDIVIDUAL LENDING

Denny George, Venkata N. A. and Trevor Mugwang'a



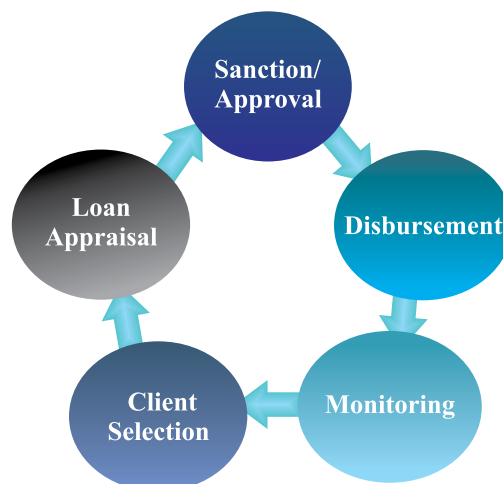
INTRODUCTION

For all the hype that surrounds it, individual lending (IL) by microfinance institutions (MFIs), still remains in its infancy in many markets. A major factor responsible for this is the relative inexperience of MFIs with such programmes. IL by its nature is market-led and needs to be heavily customised to suit local conditions.

OPERATIONALISING IL

Most MFIs implementing IL have a group-lending base, and are largely looking to meet their mature clients' needs for higher loans.¹ This means that their systems and procedures are primarily geared towards group lending, necessitating adapting these operational structures to the requirements of an IL product. MFIs intending to venture into IL should be very well aware of the need for customisation, and thus put in place adequate structures to meet the diverse requirements of both products.

It is critical to balance all the steps of the lending cycle, depicted in the chart to the left, to achieve successful lending. Inadequate focus on any of these steps will increase both credit and operational risks.



CLIENT SELECTION²

Identifying the target client segment is the first step in setting up a successful IL programme. Most MFIs automatically consider their matured group loan clients as their primary target segment. While this might be the most convenient way to start with, it usually closes doors to significant opportunities for scaling-up ... or indeed achieving critical mass as typically on around 20% of group members are real entrepreneurs needing larger scale financing. Expanding beyond group client graduation calls for a clear determination of who the target clients are and their needs. This is ideally done through thorough qualitative research, so as to direct the IL product design, marketing and communication efforts at the intended segment.

LOAN APPRAISAL

Loan appraisal in group lending methodology is usually based on simple loan cycle-based incremental amount, dependence on social collateral (i.e. joint liability) and contingent renewal (denying repeat loans to a defaulter's colleagues) to mitigate risk. In IL the client's character/reputation, commitment to the enterprise and the assessed capacity to pay is paramount. Assessing potential borrowers requires a step by step approach as outlined below:

- **Initial Screening**

Even before accepting the individual loan applications, a first-level screening is highly recommended, entailing predefined criteria such as minimum experience in the business, house/shop ownership, bank account etc. For MFIs beginning to implement IL, the screening criteria can initially be basic, and then later be developed into an internal credit scoring mechanism as the lending scales up

¹ See *MicroSave* Briefing Notes # 86 and # 87 on "Product Features of Individual Lending".

² See *MicroSave* Briefing Note # 84 "Individual Lending for MFIs – Strategic Issues to Consider First" and *MicroSave* Briefing Note # 88 "Breaking the Barriers: Market Expansion through Individual Lending".

and data for a basic scoring design is accumulated. For the clients, efficient and objective initial screening ensures that any decline decision is obtained on their basic eligibility for the loan without unduly spending time and other resources.

- ***Field-level Verification***

The credit officer must confirm the loan applicant's business activities and collect as much ground-level information as necessary to enable prudent credit decisions. In instances where a loan applicant does not maintain complete and reliable books of accounts, financial data for the cash flow analysis is usually estimated from proxies such as bills/confirmation from suppliers, physical stock verification etc. A credit officer should verify accuracy of information on the business situation and prospects provided by the client through other sources like customers, employees, suppliers and competitors, and his or her own understanding of the market and the dynamics of the client's type of business built over time.

- ***Cash Flow Analysis***

For the cash flow analysis, the Credit Officer looks at the cash generated from the business and household by taking into account all the inflows and outflows so as to arrive at repayment capacity and loan amount that can be disbursed. It is important that the appraisal considers not just business cash flows (as some MFIs do), but household cash flows too, since business cash flow is not always entirely reinvested in the business, and may be partly consumed by the household. Conversely, net inflows from other household enterprises may increase the certainty of loan repayment. MFIs should take care not to raise any false expectations by training and sensitising staff on the specific aspects to be communicated. A section on the "Dos and Don'ts" in the operations manual will help the staff and the MFI to streamline and standardise communication.

Credit officers of an MFI based in South India promised to provide larger repeat loans if clients repaid on time, but they failed to extend larger loans since loan amounts were dependent on current cash flows and not the clients' expected increased future cash flows. This led to widespread dissatisfaction among the clients.

A number of MFIs in Africa have experienced delinquency problems as a result of poor appraisals linked to overburdened credit officers, poorly managed credit officer transfers between branches and laxity in analysing repeat loans, all occurring more often during periods of high growth.

LOAN APPROVAL

Loan approvals should be conducted by a credit committee of no less than 3 members, typically including the branch manager. Many MFIs vest credit decisions in one person, often supervisors/branch managers, leaving room for errors and personal biases. Moreover, the credit committee also ensures skill and knowledge transfer and reduces the likelihood of fraudulent decisions. However, the credit committee members should be accorded adequate time to make loan decisions – without undue disbursement pressure. Clearly defined loan sanctioning authority should be distributed along the organisational hierarchy with higher level supervisors taking decisions on larger loan amounts. Credit committee guidelines should be provided to committee members to enable this process. Moreover, the committee discussions need to be recorded for reference.

One MFI in India had a system whereby the loans could be approved by designated single signatories with different approving limits at the branches and the area offices. A much greater issue was that the person who appraised a loan was often the same person who approved it.

At another MFI in East Africa, the credit committee did not meet but rather conveyed loan applications between themselves resulting in numerous instances of a member merely “approving because another member had approved”. Both cases resulted in poor decisions and substantial delinquency levels.

MicroSave reviews identified these problems, which were rectified with better processes and procedures, like loan approvals in credit committee meetings.

LOAN DISBURSEMENT

During loan disbursement, it is essential to ensure that legally valid and completed documentation is prepared. For instance, some MFIs obtain post-dated cheques from the guarantor, which provides additional comfort to the lender. Unlike group lending operations where loans are often disbursed in the field, it is advisable to make in-branch disbursements for the larger amounts involved with IL. It should be noted that legal requirements play a key role in how the loan is disbursed. For instance, in India amounts above Rs.20,000 have to be disbursed using account payee cheques.

Field interviews conducted in an Indian MFI revealed that loan processing was completed on a timely basis, but disbursement took too long due to the liquidity problems faced by the institution.

Another bank in Africa unnecessarily insisted on cumbersome central disbursement at Head Office despite its well established branch management structure and systems.

Both cases resulted in a significant negative impact on the image of their brands in the market.

MONITORING AND CLIENT RELATIONSHIP MANAGEMENT

Although it can be lucrative, IL typically presents increased portfolio quality challenges. Regular client monitoring is vital to read the warning signals before a default occurs. Monitoring schedules should be instituted in advance with a preliminary focus of ensuring correct loan utilisation, regularly monitoring the changes in business and household financials (especially for larger loans), and reminding the borrower (and guarantor) of their obligations. Even if the client completes a loan cycle without any untoward incident, but the loan utilisation was not as agreed, this should be considered negatively when assessing any subsequent loan application. Regular interaction with clients and guarantors also helps in building the relationship, cross-selling other services, and reducing the chance of wilful default. Observations and feedback from monitoring visits should be documented and reviewed, and immediate remedial steps taken where necessary.

CONCLUSION

IL definitely has the potential to grow beyond its current status in Asia and Africa. MFIs need to recognise that IL should be considered as a value proposition on its own and develop the organisational structures and capacity needed to deliver the product. Finally, an important determinant of success in implementing IL is availability of adequate liquidity. Well designed steps of the IL cycle help MFIs to manage their IL and expand their outreach and portfolio successfully. However, without the necessary institutional capacity and a systematic product development process IL can also become an operational and financial nightmare.

PRODUCT FEATURES OF INDIVIDUAL LENDING – PART 1

Venkata N.A. and Trevor Mugwang'a



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 research¹ 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.

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"

- 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 Maarg³ 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 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).

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

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, Product features of Individual Lending - Part 2, examines the other 'Ps' of Marketing: Price, Positioning, Process, Promotion, People, Place and Physical Evidence.

⁴MFIs 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.

PRODUCT FEATURES OF INDIVIDUAL LENDING – PART 2

Venkata N.A. and Trevor Mugwang'a



Product features of Individual Lending - Part 1, dealt with basic product features of an individual lending (IL) product. This note discusses the other 7 Ps of Marketing: Price, Positioning, Process, Promotion, People, Place and Physical Evidence.

PRICE

Loan price includes interest and fees paid by client and any monetary incentives paid to clients by the lender. In the absence of regular product costing, many MFIs charge the same interest rate for group lending and IL. A few MFIs charge 2-3% less in interest for IL than group loans despite the fact that more time is required for appraisal and monitoring of IL clients, and that IL tends to have higher delinquency levels. It is recommended that product costing be conducted to determine pricing.

From the clients' perspective, the total cost of a loan is more than the interest /fees, and includes a host of other costs such as foregone wages and business revenue, travel costs and time amongst others. When designing the product, the MFI must be careful to optimise the customer experience through efficient processing so that such indirect costs are kept to a minimum.

Clients seek transparency in loan pricing. Equity Bank in Africa and a few MFIs in India changed their interest rate from declining balance to flat rate basis because competitors were charging a flat rate. Depending on informal market norms and practices, flat rate is often easier for clients to understand and verify. MFIs must therefore decide how best to communicate the interest rate and fees.¹

POSITIONING

“Position” refers to the customer’s perception about the MFI with respect to its products and services. “Positioning” is the effort by the MFI to influence this perception, i.e. the effort to occupy a distinct competitive position in the mind of the target customer. This could be in terms of low transaction cost, low price, high quality, security of savings, quick turnaround time, professional service, etc. Often MFIs aim to reach out to their clients with simple positioning statements. For example: “Loans with flexible repayment options”; “Easy loans to expand your micro-enterprises”; “Loans free of group meetings or joint liability”, “Fast and prompt service: 7 days” or by highlighting value added services - high life insurance cover, added health insurance, support in marketing clients’ products, etc.

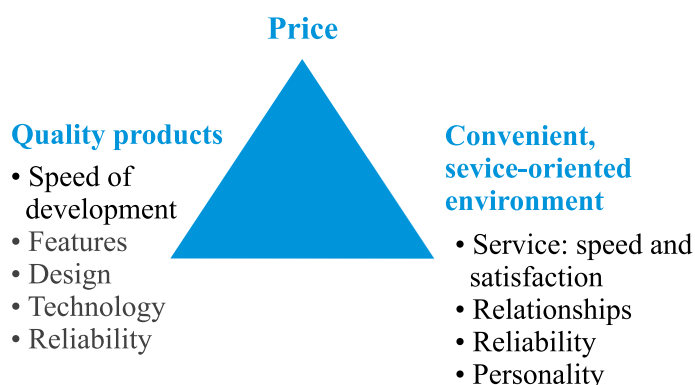


Figure 1 - Perceptual Map

MicroSave often uses the simple perceptual map depicted above as a framework to analyse the positioning of financial service providers in a particular market. MFIs need to think about which differentiators: products, service or price, are most important for their brand. An institution that positions itself in the middle of the triangle (i.e. standing for all three) will have a difficult time differentiating itself from its competitors or explaining itself to customers.² For an example, one *MicroSave* partner MFI in India has focused more on convenient and quick service to the client, while charging a competitive price – and keeping processes simple (and quick) through a narrow product range.

¹Visit <http://www.mfitransparency.org/> to learn more about transparency in pricing and calculate the effective interest rate charged by your MFI

²See *MicroSave* toolkit on “Strategic Marketing for MFIs”

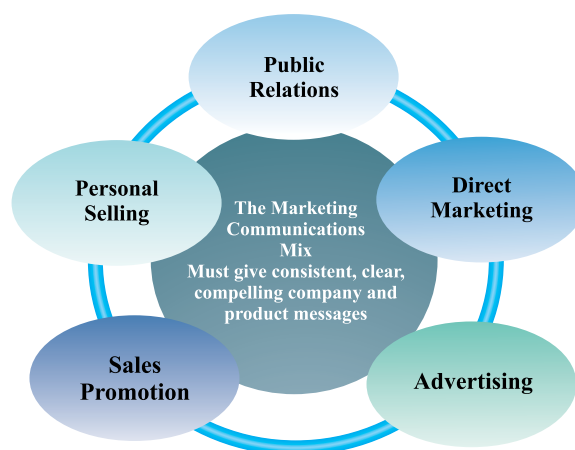
PROCESS

MicroSave has been involved in reviewing IL products and processes across many countries for over a decade. This experience has shown that there is usually significant scope for process reengineering to improve efficiencies, and to reduce risk of fraud by staff and clients. MFIs should clearly draft all processes starting from the initial area surveys to loan appraisal, approval and disbursement; loan recovery; and delinquency management. Policies and procedures manuals should be comprehensive, detailing the “who, what, when, where, why and how” of all processes with adequate internal control provisions to mitigate inherent risks. Further, these manuals should be regularly updated and readily available for staff use. Quality manuals, with process maps at their core⁴, help in staff training and reference, and simplification and standardisation of client messages including marketing collateral.

PROMOTION

Promotion can either start with informal communication by the group loan credit officer, or the IL credit officer may directly contact the entrepreneur at her/his enterprise during the initial village/area survey. Promotion, in whatever form or channel, should be characterised by clear and concise communication to prospective clients. Simple brochures in the local language with mostly illustrated product features make clients more inclined to frequently refer to them to understand basic features and requirements. The figure below depicts the elements of the marketing communications mix.

When promoting IL products, MFIs should focus most marketing energy on personal selling, perhaps with some advertising and public relations support if the budget allows, and the media are culturally acceptable amongst the targeted clientele. Promotional strategies and tactics should be aligned with the MFI’s brand, with messages focusing on the benefits the product offers the customer, not simply listing product features. Promotional channels should be carefully considered to reach an optimum number of prospective clients in a cost-effective manner.



PEOPLE

People management in the case of IL is quite involved, as product delivery procedures are more rigorous and staff training and skills more specialised than with group lending. IL credit officers typically need to maintain closer relationships with their clients, a role played by group officials in group lending. IL carries a greater risk of fraud by staff, which necessitates enhanced controls. A well designed staff incentive scheme⁵ aligned to the MFI’s portfolio outreach, growth and quality objectives is often necessary; otherwise a bias towards fewer clients with big loans may set in.

PLACE

Place refers to the accessibility of the services. Many MFIs deliver door step service to their clientele and ask the client, spouse and guarantor to visit the MFI’s branch office for disbursement only. A

³Maarg (offering exclusively individual loans) is a division of Grameen Financial Services Private Limited (popularly known as Grameen Koota), an MFI based in India

⁴See *MicroSave’s* toolkit on “Process Mapping for MFIs” for how to reengineer processes through process mapping

⁵ See *MicroSave’s* toolkit on “Designing and Implementing Staff Incentive Schemes” for how to develop staff incentive schemes

number of MFIs offer 100% door step service, including disbursement through demand drafts/account payee cheques, and loan repayment collection. Also, a few MFIs in the Philippines and Kenya have already initiated loan disbursements and repayments using m-banking solutions to reduce operating costs, as well as costs to the client - this is likely to be the future of IL in other countries as well.

PHYSICAL EVIDENCE

Physical evidence is the presentation of the product and the systems used to deliver it. Physical evidence includes how the branch looks (tidiness, space, wall painting, notice boards, furniture, etc); the appearance of operational documents and marketing materials (including give-aways); and the appearance of staff. MFIs are increasingly investing in ensuring that their physical evidence creates a positive impression in clients' minds. A well-presented branch inspires trust along with a perception of professionalism, quality customer service, and a serious place to do business.

The proof of repayment is crucial for building trust with the clients as well, reducing the potential for fraud. Technology related challenges include cases where MFIs issue repayment receipts using handheld devices that fade away in a few days, or with m-banking where repayment confirmation SMS message storage is limited by the memory available in the client's mobile handset.

An MFI in India issues manual receipts for payments received from its clients, but this was not communicated properly to the clients before availing the loan. The MFI depended on credit officers for collection of repayments, and in one instance, a credit officer committed fraud by not issuing receipts to clients for the amount received, and not depositing the received amount to the MFI. Since the MFI conducted reconciliations only between the receipts issued and cash received, the fraud was not detected for a while until a random monitoring visit to a client by the branch manager.

CONCLUSION

MFIs should finalise the product features based on their strategy and competitive positioning in the market, but should always be aware that offering individual loans is very different from delivering group-based loans. IL is a more complex business, requiring more sophisticated front-line staff, and strict adherence to a systematic loan cycle management system, backed by a robust credit administration⁶.

⁶See *MicroSave's* Briefing Note # 61 "Establishing a Credit Administration & Control Unit"

BREAKING THE BARRIERS: MARKET EXPANSION THROUGH INDIVIDUAL LENDING

Venkata N. A., Anup Singh and Trevor Mugwang'a



BACKGROUND

Introducing individual lending (IL) is often an important step towards delivering more market-led (i.e. client driven) microcredit. In most cases, microfinance institutions (MFIs) begin to implement an IL product as a reactive strategy to retain mature customers who, for a variety of reasons, do not wish to continue accessing group loans. Mature clients often borrow from multiple sources as the group loan from any one MFI often proves to be inadequate to fulfil credit needs. This note discusses the benefits of IL, the target clientele and challenges MFIs need to consider in developing the product. Experienced MFIs introducing IL cite several perceived benefits, key ones being: a) retention of mature group clients; b) targeting new customer segments; and c) diversification of services. These benefits can in turn improve growth and profitability, as well as reduce risk.

Most MFIs develop IL as an addition to their group lending programmes. Some distinct features of IL in comparison to group lending include:

- Lending to a single person.
- The group guarantee is replaced with psychological and other forms of collateral.
- Larger/more diverse loans than group lending.
- Loan size and terms are more flexible and depend on detailed cash flow analysis.
- Loan processing cost is higher for IL as the appraisal, substantially conducted by group members in group lending, is entirely conducted by the credit officer.
- IL is often developed specifically for certain target customer segments, like well established shop keepers, and other experienced small business owners.
- Monitoring and performance management, supervised in large part by group members in group lending, is substituted with close monitoring, enforcement and follow up by the credit officer assisted by supervisors.
- More skilled credit officers are required to appraise and monitor IL and to manage delinquency.
- IL has a larger scope for the use of electronic/mobile banking technology for loan disbursements and repayments, as the transactions are directly between the MFI and individual and are not through a group.

THE BENEFITS OF INDIVIDUAL LENDING

- ***Client retention***

Many MFIs, especially in Asia, offer credit to clients through Joint Liability Groups (JLG), where a group guarantee acts as collateral. However, inevitably some mature clients do not want to continue with group lending for a number of reasons including:

- o Attending group meetings requires time that established entrepreneurs may no longer be able to spare given their growing businesses.
- o Expanding businesses are often in need of more flexible loan conditions than can be accommodated in group lending. These relate to repeat loan incremental size, grace period, repayment frequency, loan term and loan top ups - amongst others.
- o Mature members may have accumulated, or may be seeking loans to acquire, physical assets that can secure the loans.
- o High value borrowers within a group are more inconvenienced than others by contingent renewal i.e. when repeat loans are suspended or delayed to resolve cases of delinquent group colleagues.

- o Members making large voluntary savings deposits may be compelled, out of security concerns, and often the need to make more frequent deposits, to make trips both to group meeting to repay loans and to the MFI branch to deposit savings.
 - o Loan amounts increase over a number of cycles to levels where group members are no longer willing to accept joint liability.
- ***Market expansion / New segment targeting***
IL is an opportunity for MFIs to tap into new segments like male entrepreneurs and well established entrepreneurs with larger loan size requirements. It may also be the only form of lending possible in a particular geographical location or cultural context.
 - ***Increase in portfolio size and profitability***
Although the initial transaction cost for IL is high, it drops significantly with good clients taking larger repeat loans thereby improving profitability, provided delinquency levels are kept low.
 - ***Diversification of income and portfolio risk***
Catering to new client segments decreases portfolio concentration thereby diversifying portfolio risk.

Disputed elections in Kenya in late December 2007 were the prelude to significant violence between Kenyan communities that resulted in significant loss of life, burning and looting of businesses and internal displacement of people. Business slowed down in clash-hit areas, even for those who escaped arson and looting, disrupting cash flow and ultimately the servicing of loans. For lenders, MFIs bore the brunt of this crisis as thousands of those affected were their clients. IL clients, who are more entrepreneurial in nature, were able to get back into business sooner with top up loans and resumed servicing their restructured loans. The relationship they had developed with their MFIs meant that going back to them was their best chance for refinancing. MFIs that had not diversified their lending to include such clients were hardest hit; it was difficult to reassemble groups as most comprised members of rival communities, the effectiveness of group guarantee was severely eroded since majority of group members were in default, and most lived in dense slums and settlements where re-establishing business was more difficult as they did not have a legal right to the land or premises they occupied. These MFIs were compelled to write-off group-based loans to a much larger extent than for IL clients.

- ***Cross-selling other financial products***
As the relationship and time spent per client deepens, the MFI has a better chance of selling other financial services like voluntary savings, insurance and investment services.

A microfinance bank in Africa failed to respond to its clients' need for an individual loan product. Its group loan clients did not see an incentive to save with the bank beyond the 20% compulsory savings required for loans. Voluntary savings accounts opened for loan clients were only used for loan disbursements and monthly deposits to fund loan instalment recoveries. Clients promptly transferred loan proceeds to active and growing business deposit accounts they maintained with a competitor who keenly monitored their account performance and, on the basis of this, granted them well tailored individual loans.

CHALLENGES IN TARGETING GROUP CLIENTS¹

Although the target client for IL differs from the typical group lending client, MFIs usually test the waters by first targeting their top end group clients for a new IL product as they already have a proven track record, and then expanding outreach by adding non-graduated clients. However, graduating group clients needs to be carefully managed as it can have negative consequences on the groups. These include:

- Groups may disintegrate if the leaders or a high proportion of well performing members leave. MFIs should have in place prudent eligibility criteria for graduating mature clients to IL, and an effective member replacement mechanism to sustain groups.
- JLG credit officers often discourage members from taking IL as it entails loss of members with good credit histories and effort to replace them. Moreover, the most common staff performance incentives are based on number of clients/portfolio size and portfolio quality - all affected by graduation of good clients. Incentives need to be designed carefully.
- IL amounts often range from \$400 to \$5,000, with a few MFIs offering \$7,000-10,000 or more. These loans are often offered to relatively better established micro entrepreneurs. MFIs should guard against only graduating clients to the high end of IL (ignoring the lower- or mid-level clients) as this raises questions of mission drift.

CHALLENGE WITH GETTING FUNDER SUPPORT FOR IL

Often banks that provide refinancing to MFIs presume IL is a forte of large consumer lending companies and cannot disassociate MFIs from group lending. Banks are wary of risks associated with IL, but can be convinced otherwise by demonstrating that MFIs with sound systems and processes, profitably offering IL do exist. A few banks have gradually appreciated the need for MFIs to grow and diversify and are willing to finance well administered IL portfolios.

A large MFI working in the northern part of India developed an IL product, in the process investing considerable time and resources, including conducting market research to understand the client needs and preferences, training credit officers on the methodology, and setting up separate branches to pilot the product. Yet, the MFI had to withdraw the product as banks were hesitant to provide funding for the product due to high IL delinquency levels experienced by a number of other MFIs that had started IL products without proper systems/processes and structures (and with pitfalls that “expert” consumer credit companies had fallen into). A great disservice to the cause!

CONCLUSION

Introducing IL can provide benefits to MFIs including retaining good clients and diversifying to new customer segments that can help them not only grow and improve profitability, but also reduce portfolio concentration risk. MFIs must, however, address the attendant challenges such as the potentially negative impact on remaining group members and group lending credit officers.

¹See *MicroSave* Briefing Note # 84 “Individual Lending for MFIs – Strategic Issues to Consider First”

CHALLENGES OF INTRODUCING INDIVIDUAL LENDING IN INDIA

Anup Singh and K Somanadha Babu



BACKGROUND

Indian microfinance institutions (MFIs) have more than a decade of experience with group lending methodologies and large indigenous institutions have emerged with group based products as the mainstay. However, individual lending (IL) is still in its infancy in the microfinance sector. While international experiences have offered valuable lessons to the Indian MFIs graduating to IL; it has to be recognised that the Indian market and the microfinance industry is somewhat different from their international counterparts that may have implemented IL successfully. Hence the lessons on IL need to be contextualised.

CASH-FLOW BASED LENDING

In India, as elsewhere, very few small business establishments have bills for purchases and sales. However, cash-flow based lending requires documented proof, or clear surrogates for information, collected from potential borrowers; or at least information that can be easily triangulated from neighbours or the community where the business is located. Accordingly, to assess the income from a business/household, surrogates like the volume of raw material (in the processing unit), stocks available (shops); family size (specifically number of earning versus non-earning members in the family); type of house and movable household assets (appliances etc.), have to be used. Since the usage of surrogates may be limited and cannot be uniform across markets, a thorough understanding of the local market and livelihood patterns is essential. Triangulation from neighbours can be effective only if the person who assesses the information is well aware of, but not biased towards (or against) the potential borrower. This might also lead to the same source of information for more than one potential borrower or one potential borrower being the source for triangulating information about another one.

Another constraint in cash-flow based lending is that third party guarantees, a prerequisite by most MFIs, may not always be feasible. Many Indian MFIs are also insisting on guarantees from Government employees, which necessarily limit the market size and may give rise to guarantors charging the borrowers for their services. However, post-dated cheques (PDCs) are backed by a strong legislation that allows the lender to proceed legally against the client, and can act as strong psychological collateral. However, getting a cheque book is difficult in many areas and/or with certain banks.

ASSETS AS COLLATERAL

Asset-backed lending requires clear legal documents establishing ownership of an asset to the borrower. In India, common household assets like land or a house is either owned jointly with other members of the family. Elsewhere across the globe, these issues are addressed by collateralising small scale productive (lathes, sewing machines etc.) and household (furniture, appliances etc.) assets. These assets are risky since they can be easily disposed by the borrower. However, more importantly, the realisation of collateral in India is simply not feasible ... indeed any attempt to seize assets is likely to be met with a formal complaint to the police against the MFI for trespassing and theft – thus initiating a criminal case!

To address these issues, Indian MFIs could use a mix of different types of collateral, depending on the loan size – several Indian MFIs are already attempting this segmented approach. Two of the large MFIs from South India, use a mix (one or more) of the following:

- PDCs from the borrower (however in case of wilful default, the borrower can issue stop payment instructions!)
- Guarantee from a government employee (guarantor also should provide PDCs)

- Title Deed of any fixed asset (mortgage)
- Hypothecation of movable assets (say a tractor)

OPERATIONAL ISSUES

One of the basic features of an individual loan product is the need to tailor it to the needs of different clients and their businesses. This is a complete shift from the typical offerings of most MFIs which revolve around standardised group loans. Some Indian MFIs attempt to get over this problem by offering larger IL loans, which are nevertheless standardised, with an increasing loan size for each successful cycle. This approach divorces the amount sanctioned from the real financing need of the business – potentially compromising both the business and the loan itself. Loan structuring to suit the needs of the business is an important step in designing an IL product, and involves assessment of the business' cash flows and seasonal issues.

Cost considerations have forced group-lending MFIs to establish a modest branch infrastructure, which suits the operational model because clients rarely visit the branch office. However, in the case of IL, branch-based disbursements and/or repayments are necessary for a variety of reasons:

- Disbursements and repayments are individual-specific and so the cost involved in transacting with each individual client separately in the field is high.
- Clients of this segment may demand flexibility in disbursement and repayment dates and times.
- Repayment amounts are generally higher and handling higher amounts of cash in the field is risky for the MFI and its staff.
- An IL programme is an exercise in relationship management, which calls for regular interaction and a more comfortable branch infrastructure.
- Larger loan amounts need to be disbursed through cheques (legal requirement as per Income Tax Act, for amounts of Rs.20,000 and above).

These operational issues necessitate better infrastructure and larger and relatively elegant branch offices close to the market area. Most Indian MFIs will need to establish separate branches for their IL operations. This necessarily means a significant increase in costs – both for infrastructure and also for routine operations.

HUMAN RESOURCES ISSUES

IL credit officers have to assess and evaluate businesses, identify the credit needs and structure loans accordingly. This requires them to be significantly more qualified than their group-based lending counterparts. Often recruitment of IL credit officers in the required numbers for work in semi-urban and rural areas is a challenging task. Most MFIs do not have the in house capacity to provide training on the skills necessary for IL. Unlike group lending, it is difficult for IL officers to learn skills “on-the-job”, because the loan sizes are higher, which results in enhanced credit risks. To initiate IL, MFIs are likely to need assistance from an external agency to train their staff ... or to buy-in trained staff from other MFIs that have IL programmes.

Designing and integrating staff incentive systems for IL are also often challenging. Institutions offering both group and individual loans face resistance from group lending credit officers, reluctant to let go of their good group-based clients.

FINANCIAL MANAGEMENT

Adding IL to the existing group lending portfolio often creates substantial demand for cash. Many MFIs do not plan their liquidity to respond to this increased demand. This increases the loan application to disbursement time for clients and thus creates a reputation risk.

In addition to increased infrastructure costs, the operational costs of an IL programme are also higher. Loan structuring, appraisal and monitoring involve resources of higher quality and quantity. Combining these with costs associated with delinquency (in terms of provisioning etc.), individual lending becomes a costlier programme for the MFI - but of course this should be off-set by the larger loan size on which interest is being charged. To arrive at the pricing of the product on a rational basis, and operate efficiently, a costing exercise should be performed.

MANAGEMENT INFORMATION SYSTEM (MIS)

A robust MIS is essential for an IL product – particularly if flexible repayments are to be accepted to reflect the borrower’s business cycle. Most of the MIS applications being used by Indian MFIs are designed to handle standardised products, and lack scope for customisation to suit the needs of IL. MIS for IL must be able to capture the details of client’s business and household assessment, generate repayment schedules for different amounts, different tenures (6 months, 12 months, 18 months and so on) and different cycles (monthly, fortnightly, weekly or lump sum repayment).

CONCLUSION

IL is a very different business as compared to group-based lending and presents challenges that need to be appreciated by MFIs in India. Across the world, MFIs are increasing the size and scope of their IL operations to respond to the demands of their graduating clients and offer services to the critical “missing middle”. This trend is now beginning in India too, and MFIs should be aware of the challenges as well as opportunities presented by IL.

RISKS AND CHALLENGES IN INDIVIDUAL LENDING

Sandeep Panikkal, Venkata N.A. and T.V.S. Ravi Kumar



INTRODUCTION

Many Indian microfinance institutions (MFIs) introduced the individual lending (IL) methodology as a natural progression from the group lending methodology. MFIs want to grow their portfolios quickly while satisfying the needs of mature clients, some of whom demand larger loans that are not met by group lending norms. As a result, several MFIs have developed and expanded IL portfolios very rapidly.

Interestingly, as banks and non banking financial companies (NBFCs), the traditional providers of IL products, have become more cautious due to the perceived higher risk in IL, MFIs are aggressively increasing their IL portfolios. There is a risk that some of the clients filtered out by banks and NBFCs on the basis of their dubious credit worthiness may take loans from MFIs with less stringent appraisal, monitoring and control systems, thus exposing the MFIs to higher risk.

The main aim of this note is to review the risks observed in the IL products offered in India, and offer strategies to mitigate them.

RISKS IN THE IMPLEMENTATION OF INDIVIDUAL LENDING

Preference of Collateral Based Lending: All Indian MFIs' IL programmes claim to lend based on cash flow. But in practice, many MFIs are substituting cash flow-based lending for taking collateral like gold or real estate. Collateral-based lending raises several issues including valuation, monitoring, recovery, and liquidation. There is also the added risk of ensuring effective assessment of the quality of the gold and then storing it securely.

Poor Product Design: IL in most Indian MFIs tend to replicate the pattern of standard fixed loan amounts that increase with each loan cycle, rather than the loan amount reflecting the actual need of the client's business. Fixed loan amounts for each loan cycle is likely to lead to under-lending to some clients and over lending to others.

Also, while designing the IL product, MFIs tend to copy the features of competitors' products rather than designing the product based on clients' needs and preferences. Copying products and launching them without proper research in often very different market conditions could lead to poor uptake of the product and increased delinquency by essentially dissatisfied clients.

Weak Underwriting Process: Key reasons why MFIs do not conduct rigorous cash flow analysis include:

- Limited capacity of their staff;
- Sales-focused incentive schemes that reward large scale disbursements; and
- Highly ambitious strategic plans often developed for private equity investors, who are in a hurry to exit.

Since sound cash flow-based lending takes time, even trained staff may often cut corners in this critical area.

An MFI working in South India since 2005 started its IL product with huge fanfare in 2007 to diversify its product range and deepen its market penetration. The MFI approached IL as a separate product of its microfinance operations, and recruited new staff to run the new department. However, the MFI had to withdraw the IL product in less than a year. The following problems were experienced:

- The new staff were not properly trained, which resulted in poor client selection, poor cash flow assessment, inadequate credit analysis and faulty loan structuring.
- The time gap from loan application to loan disbursement was too long, extending up to 2-3 months.
- The organisation tried to continue with its existing JLG monitoring system which resulted, in hobbling efforts of field staff to read early warning signals of problems.

Not Establishing Credit Histories: The pressure for growth has led some MFIs to offer IL to new clients or to clients who have only completed one loan cycle and thus have no substantive credit history. Credit discipline of such clients is also suspect. This, in the absence of a thorough cash flow analysis significantly increases the programme's credit risk.

Loan Appraisal/Approval Dependent on One Person: Even for IL, the branch managers are generally performing the loan appraisals and the approvals, as in group lending. Since the loan amounts are generally high and their sanctioning is largely dependent on the wisdom of one person the risk of delinquencies/ defaults due to poor client appraisal is high. There is a general tendency to approve larger amount loans to mature clients irrespective of their business, even when their cashflows are not adequate to repay the loan.

WHO SHOULD CONSIDER INTRODUCING IL?

MFIs may want to consider introducing IL if they:

- Have good performance in group lending for 3-4 years.
- Want to minimise multiple borrowing among their customers due to insufficient loan amounts.
- Are facing rising dropouts because good members are leaving due to delinquent members.
- Are interested in diversifying their product offerings to the micro-enterprise segment.
- Have the institutional commitment and will to make cash flow based lending work.
- Have strong internal audit and controls, and sound governance structures and systems.
- Have adequate funds to finance the larger loans entailed.
- Have the MIS to manage this, more complex, lending.

RISK MITIGATION

Design Product and Terms Around Needs: To design the IL product, MFIs must conduct market research to understand clients' needs and preferences. MFIs must pilot test the newly designed IL product before roll-out.

To scale up IL, product innovation should address clients' business needs. For example, during the monsoons in agrarian areas, people buy goods on credit from shops. This reduces the cash flows of shop keepers, making it difficult for them to repay loans. Likewise, during harvest, marriage and festival seasons, cash flows increase, allowing shopkeepers to repay more. Flexible repayment schedules may be more effective in these cases. BASIX has been successfully offering cash flow based repayments for their repeat loan customers.

It may be appropriate to have cycle-based loan ceilings, and within this limit, clients should be given loans as per their business needs. Loan amounts should be ideally equal to 2 to 3 rotations of the client's working capital. After starting with working capital loans, MFIs can then move to financing capital investments of mature clients for longer periods.

Allow for Emergencies: Cash flow based lending, based on analysing the business and household cash flows are central to IL. Some proportion of the client's total net income should remain after loan repayments as a cushion to meet business and household emergencies. This portion ranges between 50% and 75%, depending on the organisation and environment. This adjusted repayment capacity indicates the maximum amount that the client can afford per period towards a loan repayment. Multiplied by the number of payments, it provides the total maximum loan plus interest amount.

Loan Committee: The loan should be approved by a loan committee to lessen the risk of depending on one person's perspective. Typically, the loan committee should not be chaired by the loan appraiser. Ideally, the committee may comprise 2-3 staff involved in direct appraisals (two from different branches/areas) and one either from the area or regional level and an additional from finance (in some larger cases), if needed. The loan committees may be held at the branch level, area level and region level depending on the loan amount, but should meet on a regular basis to ensure rapid assessment and disbursement of loans.

Human Resources: MFIs must invest in their human resource capacities by hiring staff with the required capacities and providing appropriate training to existing staff before introducing an IL programme. Staff involved in IL need to have the capacity to conduct cash flow analysis and business analysis in the field. They must also be able to identify various risks in the client's business. Head office staff must have market research, piloting and product development skills – or buy them in.

Delinquency Management: All the risk mitigation strategies mentioned above are part of the first step in delinquency management – prevention. The other two facets of delinquency management, monitoring and response/action, must also be addressed. Unlike group lending wherein delinquency management measures are built into the model, IL offers no such cushion. In absence of any collateral (in most cases) it becomes all the more important to have prompt and rigorous (but non-intimidating) delinquency management systems¹.

Last Resort Methods: Many MFIs require a guarantor or some collateral like post dated cheques or jewellery to take an individual loan. If any client fails to repay, the immediate resort is to contact the guarantor to repay the loan as promised, or to liquidate/activate the collateral. These options provide some legal and psychological comfort in the absence of group guarantee.

CONCLUSION

The lure of “big ticket” loans and higher profitability is attracting growth oriented MFIs to aggressively push for IL without considering the inherent risks. IL has its own idiosyncratic needs like cash flow based lending; analysing business needs and risks; bringing flexibility in product features; building staff capacities and processes that must be followed for successful implementation².

¹Refer *MicroSave* toolkit on Delinquency Management for IL MFIs

²*MicroSave*'s Individual Lending toolkits for Credit Managers and for Credit Officers are available on www.MicroSave.org

DEVELOPING CASH FLOW BASED INDIVIDUAL BUSINESS LOANS

The Experience of Equity Bank with Biashara Imara

Trevor Mugwang'a



Through its Action Research Programme, *MicroSave* learns and disseminates lessons relating to market-led microfinance. This Briefing Note highlights key lessons from the experience of its partner Equity Bank, in designing, testing and rolling out a cash flow based individual business loan product.

WHY CASH FLOW BASED LENDING?

By 2003 Equity, then a Building Society, was undergoing rapid growth in its asset base and client numbers, as a result of adopting an increasingly market-led approach to serving its customers. Its suite of credit products consisted of salary based consumer loans, a business loan product secured by legally perfectible collateral and agricultural loan products developed for the tea and coffee sectors.

The decision to venture into cash flow based micro credit was driven by a realisation that there was a substantial, and largely unmet, demand for this type of product. Equity wanted to grow business by attracting a new type of loan client: one who did not have access to large amounts of traditional collateral. This product would have other benefits too as it would further diversify credit risk. Furthermore, due to higher market rates for cash flow based loan products, it offered the potential for better returns on credit investment ... as long as costs and risks could be controlled.

HISTORY OF INITIAL PILOT TEST

Equity ran an initial pilot test of its *Biashara Imara* (literally translated as “stable business”) product in 2003. However, the pilot test floundered despite repeated extensions. This was due to the following:

Pilot Test Structure: Unfortunately some problems were “designed in” to the structure of the pilot test. The relatively long distance of the pilot branch from Head Office compromised Equity Bank’s ability to actively monitor and address issues around the pilot test. In addition, credit officers assigned to the product were already administering other credit products.

Competing Priorities and the Challenges of Growth: The *Biashara Imara* pilot test reflected challenges within Equity, which was growing very rapidly. These included: insufficient capacity in credit administration at Head Office to support pilot branch staff in addressing problems and refining the product; and an MIS system that was insufficiently customised for the new product. Worse, there was frequent rotation of branch staff and management to other branches to respond to demands fueled by rapid growth in the branch network. In this environment, the product continually competed for resources and the attention of branch management and staff.

Product Operation: During the development phase, Credit Officers failed to screen out unsuitable applicants early in the application process, resulting in high costs of loan processing and field visits. Client experience was inconsistent with different communication of product features - such as eligibility requirements and repayment periods and delays in processing loans.

Missed portfolio growth and quality targets compromised refinement of the product and necessitated extensions to the pilot test, followed ultimately by the decision to cease the pilot and start a new one at a different branch.

REVISED AND SUCCESSFUL PILOT TEST

Learning from its earlier experience Equity established a micro credit unit within its credit department and mandated it to oversee a new pilot at a branch nearer to Head Office.

The pilot team reviewed results of the earlier pilot and decided to refine the product features. Top of the list were the loan amount and term, which were restructured to ensure their appropriateness for different types of businesses. This avoided straining borrowers' business cash flows and stemmed the tendency of customers to seek multiple funding with other MFIs. Continuous client feedback was essential in achieving an appropriate balance for different types of businesses.

The pilot team and pilot branch staff interactively and objectively assessed the extent to which inadequate differentiation between *Biashara Imara* and other products resulted in client confusion and inadvertent take up of an inappropriate product. Typical problems with differentiation revolved around overlapping loan amounts and collateral requirements as well as inconsistent loan durations, and different processing procedures.

CLOSE MONITORING RESULTED IN A NUMBER OF POSITIVE CHANGES:

Policies: An appropriate policy for early payoff of loans was determined to check the tendency for clients to payoff loans in order to qualify for bigger loans often leading to increased default.

Procedure Manuals: These were developed for integral processes and activities including business appraisal where there are few formal accounting records, carrying out chattels assessment, documentation, the conduct of branch credit committees in mitigating the risks of bad loans, default and fraud, and the management of arrears.

Pricing: Refining the product's pricing entailed balancing the need for cost recovery and profitability, with the need for simplicity and clarity within the pricing structure through avoiding multiple charges. In particular, clients resented indirect costs such as those of third parties for perfecting certain securities. There was the additional need to incentivise good client performance, for example through interest rebates for on time payments, and penalties for arrears.

Staff Training: The implementation team developed and continuously refined a detailed class- and field-based training program on loan appraisal, monitoring and delinquency management. This was accompanied by a cessation of rotation of officers from other products to cash flow based loans products without appropriate training, an activity that had been determined to result in portfolio quality deterioration in the initial test.

Remuneration of Biashara Officers: The team and the bank as a whole came to terms with the need for careful structuring of remuneration for *Biashara Imara* loan officers in relation to credit officers' handling other credit products. Administering individual business loans is considerably more labour intensive than issuing salary loans, especially with regard to client appraisal, loan monitoring and default management, all underpinned by ability to make prudent judgments and substantial field based work.

CURRENT PERFORMANCE

Biashara Imara continues to rollout and extend, taking its place as one of Equity Banks' valued products. *Biashara Imara* reaches a segment of customers that might otherwise go un-served by the bank. Within a year of rollout the portfolio had reached more than 25,000 outstanding loans totaling \$8 million.

During the pilot, most of *Biashara Imara* clients got to know about the product and apply for it through positive word-of-mouth, a trend that has sustained in rollout. Equity recognised this and has continued

to strengthen cross selling of *Biashara Imara* and other products to existing and potential clients through credit officers and current clients who interact with potential clients, guarantors, referees, suppliers, customers' community leaders and others away from the branch.

KEY LESSONS IN PILOT TESTING

So what can we learn from this experience?

Follow a well structured process: When introducing an individual cash flow based business loan a structured process to develop a pilot prototype is needed. Then, it should be subjected to a well planned, controlled and monitored pilot test. It is necessary to have clear targets and a process to evaluate the product along the way culminating in an objective extension, rollout or cessation decision.

Conduct Design Research: To minimize costly product redesign, conduct research to develop and test the concept in order to produce a prototype with distinct and differentiated features that meet client needs.

Ensure Capacity and Support: Address capacity at Head Office by considering oversight, abilities and structure. Through this analysis, build a cross functional and proactive product development team to oversee the whole pilot test. The team helps to ensure that project timelines and standards set in the pilot test are met. At branch level, ensure capacity by having staff trained appropriately and dedicated to the product. Cultivate branch management buy-in and support, which should ensure that necessary operational resources (e.g. logistics for desk and field activities of credit officers and supervisors) are provided.

MIS: The MIS should fully accommodate product features. It should have the capability to produce reports for productivity and trend analysis in addition to accurately reporting arrears to facilitate timely corrective action where necessary.

Procedures: Develop effective and efficient product procedures with accompanying operational manuals to guide staff administering and training on the product.

Careful monitoring: Conduct monitoring with accompanying documentation of test issues to identify how to refine the product as well as strategic decisions (cessation, extension or roll out) on the test as a whole. Obtain regular client feedback in a structured way and ensure this feedback is included in pilot test reporting.

Scale: Ensure that the scale of the test is adequate to reveal any deficiencies in the product's design and processes. Training adequate numbers of new frontline staff and over an adequate period will facilitate eventual roll out.

MANAGING RISKS IN CASH FLOW BASED LENDING

A comprehensive and effective institutional credit risk management framework, complemented by an effective new product development risk management methodology, is essential in minimising loan default and consequently the need to resort to loan recovery through collection of collateral. The scope for realisation of unregistered collateral through legal enforcement and sale for this type of product is usually limited and rarely economical. It is more beneficial to place emphasis on well thought through product features, a solid appraisal system, effective client monitoring and client incentivisation for on time payment, all of which should be developed through careful research with potential clients and perfected through pilot testing.

MICROFINANCE INSTITUTIONS AND SALARY BASED CONSUMER LENDING

Trevor Mugwang'a and David Cracknell



A growing number of microfinance programmes provide consumer loans to low income salaried workers. Often these workers use their employment status to borrow on behalf of poor relatives and to cover for family emergencies. Under these loans monthly deductions are made from salary accounts maintained with the financial institution or payments are made through a check off whereby an employer makes direct payroll deductions and remits the balance to the lender. This note draws on the experience of *MicroSave's* Action Research Partners (ARPs).

WHY SALARY BASED LOANS?

A common perception is that such loans represent a low risk, high return opportunity. Low risk because the loan is secured on terminal benefits and collection is assured, high return due to low expected operational costs and higher rates of efficiency.

NEW RELATIONSHIPS AND NEW CUSTOMERS

When an institution provides salary-based loans for the first time, typically, it represents a move to new market segment, with different clients with whom the institution has had no prior relationship. In most cases the principle relationship moves away from a direct relationship with clients based around assessing the credit worthiness of individuals, to a direct relationship with employers.

However, most new entrants have to operate in a portion of the market segment that is less attractive to commercial banks and that carries a much higher level of inherent risk. Commercial banks retain salary-based lending to premium private sector companies by offering loans to their employees at low rates of interest that microfinance institutions cannot match. Several ARPs reported losing clients to commercial banks when they started to process salary deductions.

DEMAND FOR LOANS CAN QUICKLY OUTSTRIP FUNDS

Salary based loans provided through larger employers, can quickly exhaust the supply of available funds.

“Banks often use salary based lending to provide loans during periods of surplus liquidity. If microfinance programmes do not have surplus liquidity there is an immediate question mark on whether they are best placed to offer salary-based loans.”

An ARP Director

MANAGING RISK

Key to profitable salary based lending work is risk management. The remainder of this briefing note discusses risk management strategies used by ARPs.

USE PILOT TESTING TO IDENTIFY OPERATIONAL CONSTRAINTS

Pilot testing is intended to identify operational constraints and manage risk. During pilot testing, processes, procedures and systems are refined, marketing approaches developed and the product design finalised. Careful attention to detail at this stage reduces risk and saves money. Pilot testing with four ARPs revealed common issues:

Systems: Institutions new to consumer lending, must ensure their banking information systems are

configured to efficiently and effectively manage the lending and collections processes. Some banking systems lack the facility to continuously “hunt” designated deposit accounts for funds to repay loans. This facility is particularly important when actual salary payment dates are variable as they are with many public sector bodies. A less efficient method of control is to flag deposit accounts of customers with outstanding loans, and check repayment history before allowing withdrawals. Though a flag usually does not prevent withdrawals using other channels such as ATMs.

Reporting: Reporting systems need to be developed that can track trends, not only by credit officer and branch, but also by employer. Exception reports are important, particular attention needs to be focused on the first missed payment in case this results from a ghost client or a failure to set up the deduction from the payroll.

Internal control and fraud: Salary based consumer lending is usually characterised by client turnover, and more indirect relationship with customers. These factors significantly increase the risk of fraud. All ARPs report incidents of fake appointment and recommendation letters. Some have reported ghost loans and embezzlement of instalments.

MANAGE EMPLOYER RELATIONSHIPS

Select employers carefully: In most cases mitigating portfolio risks in consumer lending involves a careful selection of eligible employers. In choosing employers the institution needs to consider a range of factors:

- **Financial stability:** Including assessing trends in growth and profitability, and their record of paying salaries, in full and on time.
- **Type of employer:** Processing of loans is easier when dealing with nearby employers, but the demand for loans may be limited and the number of employers involved correspondingly greater. Public sector employees are often considered low risk. However, delays in processing deductions appear common in many ARPs.

Manage Employer Relationships: The relationship between the employer, its payroll function and the financial institution requires careful management. Payroll departments are in a unique position to see the deductions being made from individual employees, and to determine which deductions should be made.

- Improve information flow to increase the speed with which the employer makes deductions.
- Make it as easy as possible for the employer to calculate and remit the repayment, some ARPs submit a deductions schedule monthly.
- Try to obtain advance notice of any retrenchments.
- Maintain close contacts and follow up.
- Due to the potential for “rent seeking” institutions need to establish very clear guidelines on how this relationship is to be maintained and the appropriate level of corporate hospitality.

CONTROL REPAYMENTS

A key success factor reported by several larger ARPs is the ability of an institution to control repayments. Cases were reported of banks holding the payroll refusing to make transfers from employees accounts, due to pre-existing loan commitments of customers. This means ensuring where possible that salaries are paid through the institution, rather than the receipt of deductions. Risk reduction strategies included:

- Increasing the number of days before the loan is issued to allow validation of data.
- Issuing loan on receipt of first salary payment.
- Obtaining commitments from employers to validate data.
- In some countries it is also possible to verify employment with central registries.

Of course, unless the microfinance programme is a licensed deposit taking institution, they will not be able to accept salaries.

ENSURE LOANS ARE AFFORDABLE TO CUSTOMERS

Assessing whether customers can afford the requested loan is especially important in markets where consumer credit is easily available. Calculating affordability is intended to safeguard portfolio quality by controlling for over indebtedness. In some markets in East Africa there is national legislation stipulating the maximum monthly deduction as a percentage of salary, and a requirement to disclose payroll deductions on the payslip. In other markets, such as South Africa, the lender can consult a national loans register or credit bureau to obtain information on potential customers.

STRENGTHEN CREDIT CONTROL AND ADMINISTRATION

Consumer lending is often extremely popular. Portfolios can grow rapidly. This rate of growth can significantly increase operational, liquidity, and credit risk. An important step is to strengthen credit control and administration functions.

Credit analysis: Strengthening the credit analysis function, through the production and analysis of dedicated reports to support the collections function and to identify sources of risk. A key area to examine is portfolio concentration; this should be done in several ways, by type and size of employer, by value – both across an institution and within a district, and by risk profile. This manages covariant risk.

Staffing: A large volume of salary based lending usually requires the strengthening of the collections function, with credit analysts, collection centres and legal departments and the application of IT solutions.

Process mapping and compliance: Use process mapping to ensure that appropriate, risk sensitive procedures have been adopted. Once adopted ensure high levels of compliance. Equity Bank found that merely by ensuring compliance to policy, risk fell and income (through the application of penalty fees) increased.

USE TECHNOLOGY TO REDUCE RISK

Scorecards: In a stable market with well-known predictors of behaviour, such as salaried employees, application and experiential scorecards can significantly reduce selection risks.

Collections Software: Salary based lending, is normally provided to those with a relatively stable employment history. However, the huge volume of loans makes the tracking of overdue loans and promises to pay challenging. Credit Indemnity, in South Africa, used dedicated collections software and a call centre, to provide immediate loan follow up.

ANTICIPATE COLLECTIONS DIFFICULTIES

With consumer loans the direct lending relationship is usually partly replaced by a corporate relationship between the Head Office and the private company or Government Department. Where responsibility for a repayment problem can lie either with the employer, based in the capital city, or the employee based in a rural town, assigning responsibility for the resolution of issues can be very difficult.

CONCLUSION

Contrary to the expectation of many of our ARPs, a decision to move to salary based lending is not a forgone conclusion. If demand is to be met at an appropriate risk, institutions need to give careful thought to the availability of funds, management of risk, collections methodologies and the creation of new business relationships.

WHY DO MICROFINANCE CLIENTS TAKE MULTIPLE LOANS?

Venkata N. A. and Veena Yamini A



INTRODUCTION

Since 2004 microfinance in India has gained impetus, and the sector has grown very rapidly. This trend was reinforced by the commercialisation of the sector, which is often characterised by increased competition for clients and a clear objective to seek profitability – resulting in more than one microfinance provider (MFI) operating in an area. While this offers members a scope to borrow from multiple sources, it can also lead them to over-indebtedness.

The aim of this note is (a) to understand and present the rationale and impact for multiple borrowings from a client perspective; and (b) to discuss how the MFI and its leaders perceive the issue and its implications. The observations and findings of the authors are based on extensive interactions and conversations with borrowers, MFI staff and leaders in the field.

The *State of the Sector Report*, 2008 estimates the extent of multiple borrowing as prevalent in 10% to 20% of MFI clients.¹ However, actual incidence may be much higher, especially in mature markets or in markets where there are many MFIs competing for clients in the same area, such as the southern states of Andhra Pradesh, Karnataka and Tamil Nadu.

CLIENTS BORROW MULTIPLE LOANS FROM:

- Moneylenders
 - o Registered - Pawn brokers, local finance
 - o Unregistered - Thakur, Seth, Patel
- SHGs – internal corpus, bank linkage, etc.
- Several different MFIs
- Different branches of the same MFI through group and individual lending (IL) methodologies

Clients borrowing from different types of lenders to meet their diverse needs have created some concerns. The problem is complicated by the limited capacity of MFIs to limit loan use to ‘productive’ purposes. Clients often use multiple loans for “non-productive” purposes, such as meeting emergency expenses or for another more viable or lucrative opportunity.² Multiple loans are commonly used for emergencies (indeed emergencies are often a trigger, motivating clients to seek credit from other MFIs). If the clients receive funds at an inappropriate moment in their business cash flow cycle, they may also be tempted to divert them to other needs like education, festivals, consumption etc.

However, the real concern is with clients taking multiple loans from different MFIs who have similar products with rigid instalment schedules (unlike most informal/semi-formal loans for moneylenders, SHG groups etc. which provide the flexibility to help clients manage repayments). The chances of getting over indebted are high due to the inadequate control mechanisms in MFIs to prevent multiple lending.

¹Srinivasan, N., “State of the Sector Report 2008”, Sage Publications, London, UK, 2009.

²See *MicroSave India Focus Note 7* “Are Loan Utilisation Checks Necessary”

“Our field staff are very aware of the number of loans each member has taken from different MFIs. But, they don’t reveal the information nor do they capture it in the loan documents as their incentives mainly depend on number of clients, outstanding and repayment percentage”.

Views of a Senior Manager (of a Tier-II MFI) on Multiple Loans

From the *client’s perspective* there are quite a number of reasons for taking multiple loans including:

- Receiving inadequate loans for business expansion as the loans are based on loan cycles rather than cash flow;
- Repayment of existing (high interest) loans with money lenders;
- Borrowing to meet other requirements such as marriage, funeral, construction of house, health, education etc;
- For starting another business by the member/spouse/children;
- On-lending (like money lenders) to neighbours/friends;
- Purchasing gold jewellery in order to create savings;
- Unexpected receipt of loans (while already in debt) from banks/ government;
- Repayment of existing loans with other MFIs/ SHGs.

A study conducted at Ramanagaram³ for three months period, shows that 19 of the 20 households involved in the study were indebted to more than 2 MFIs/SHGs; 10 households to more than 4 MFIs/SHGs; and 2 households to a total of 7 MFIs. One of the common reasons cited for multiple borrowings was the inadequate loan size. 10 of the 20 households were spending more on loan repayments than on food. An analysis conducted by GFSPL⁴ in Kolar showed that 11% of the MFI clients have loan accounts with 2 or more MFIs, with 20% of total loan amount disbursed is to clients with accounts in multiple MFIs.

A recent study⁵ on stress levels of kendras (centres) conducted at Grameen Koota suggested that over the years, the older kendras have learned to manage stress by adopting improved strategies. For example: hanging on as the member gradually pays off her loans; managing the delayed payments for the delinquent client; saving up amounts as small as Rs.10 per member per week to manage large delinquencies; starting group-based income generating activities that help them generate income and build affinity; adopting more rigorous member selection practices; checking loan utilisation even when it is not required; and not permitting members to join who are members of too many other MFIs.

From the *MFIs’ perspective*, there are quite a number of potential ways for multiple borrowing to happen:

- MFIs’ aggressive growth plans force poaching the existing clients of other MFIs as the members have proved their credit history and they have fair knowledge of joint liability group norms and credit discipline;

³Kamath, Rajalaxmi, Arnab Mukherji and Smita Ramanathan, “Ramanagaram Financial Diaries: Loan Repayments and Cash Patterns of the Urban Slums”, IIMB Working Paper No. 268.

⁴Grameen Financial Services Private Ltd for the Association of Karnataka Microfinance Institutions (AKMI).

⁵Excerpts taken from the report ‘The Voice of the Kendras: Diagnosing Internal Stress’ a research conducted by teams of Grameen Koota and MicroSave in June and July 2009.

- Clients do not reveal their borrowings/membership with other providers (and also MFIs do not share the information with other MFIs);
- Loan sizes are based on cycle rather than cash flow;
- Different members from the same family or household take loans;
- Borrowers avail multiple loans by taking advantage of multiple spellings/names on multiple identity cards;
- Front line staff want to reach their monthly targets and thus ignore multiple borrowing;
- Front line staff do not reveal that the member has already taken multiple loans from different institutions as they do not get any incentives for revealing this information.

IMPLICATIONS

When borrowers resort to multiple borrowings to smooth their cash flows, they must bear a heavy burden.⁶ This includes: transaction, opportunity costs and time spent in various group meetings; household over indebtedness; stress of meeting multiple loan payment schedules; increased risk of inability to pay; stress of increasingly unstable joint liability agreements; and ultimately the risk of defaulting. For MFIs, there is a high risk of default and drop out, and a risk that staff and operational resources may be shifted to areas where a proliferation of MFIs is eroding portfolio quality.

CONCLUSION

It is difficult to attribute such multiple borrowings just to unmet demand for credit from borrowers, or to dumping of loans by the MFIs on clients well versed with the MFI methodology.⁷ However, MFIs can reduce the incidence of multiple borrowing. The appropriateness of disbursement timing can be improved through studying microenterprise cash flows by type, and changing operational policies to reduce mismatches between client cash flows and the timing of loan cycles.

Another strategy is to implement individual cash flow-based lending. This entails a special product design of which the terms and conditions are based on the actual needs of the clients' business; offer differential loan tenure and repayment schedules for each borrower based on cash flows; specialised recruiting, training and incentivising of a person only for cash flow analysis and develop specialised underwriting tools, analysis, process and approval.

At policy level, MFIs can: (a) initiate state level MFI-forums like Association of Karnataka Microfinance Institutions (AKMI) and share data about delinquent clients and areas of multiple loans; (b) also to adjust their field officers' targets to be more realistic, and (c) graduate clients with need and good credit history to individual lending with higher ticket size.

⁶Krishnaswamy, Karuna, "Competition and Multiple Borrowing in the Indian Microfinance Sector", IFMR-CMF Working Paper, September 2007.

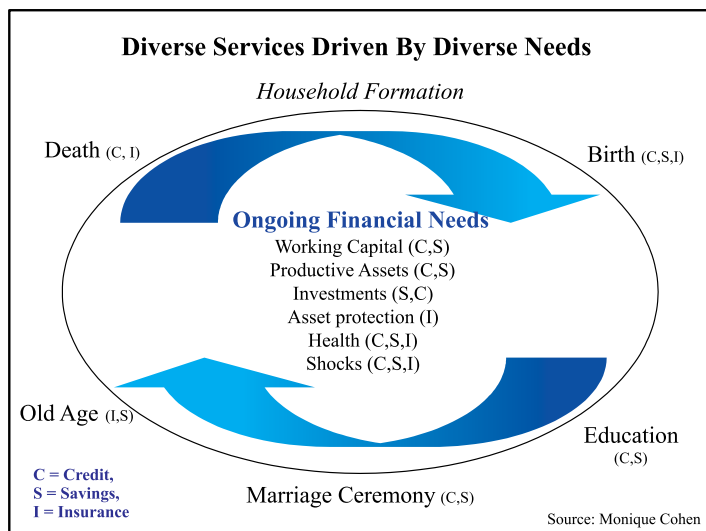
⁷Srinivasan R. and Rajyalaxmi Kamath, "Microfinance in India: Small, Ostensibly Rigid and Safe", IIM-B Working Paper, 2009.

ARE LOAN UTILISATION CHECKS REALLY NECESSARY?

Graham A.N. Wright



The microfinance industry has traditionally seen poor people's needs for financial services simply as "credit for enterprise". Today however, it is generally accepted that poor people also need access to lump-sums of money so that they can send their children to school; buy medicines; respond to other shocks and emergencies that beset their households; celebrate social and religious festivals; save up for old age etc. It is clear that poor people need a range of "financial services" not just the traditional, mono-product, working capital loan.



Thus, the typical 4-12 month working capital loan repayable in equal, immutable, weekly instalments does not adequately reflect the changing realities of poor households – whose income and expenditure flows can change significantly according to the season, the advent of festivals or shocks to the household economy. Low-income households need prompt access to emergency loans (a role played by family/friends or the informal sector moneylenders in most countries) or to increased flexibility in the repayment schedules set by financial institutions seeking to serve them.

As a result, traditional microcredit projects throughout the world have faced loan diversion: borrowers using their loans not for the purpose given on the loan application form or prescribed by the project, but for another more pressing purpose. Often loans are diverted for "providential" or "non-productive" purposes, to meet emergency medical or education expenses (both of which, incidentally, can also be seen, in the long run at least, as "productive"). But loans are also often diverted because the farmer sees another more viable or lucrative opportunity. Given that cash is "fungible" and the complexity of farmers' household economies, it is increasingly clear that trying to tie loans to specific uses without addressing other needs and opportunities is naïve at best.

Loan utilisation checks are an integral part of the original Grameen Bank methodology – and are viewed as essential by many MFIs in India. But if you ask almost any field officer, they will tell you (away from their supervisors) that the loans are not always, or even often, fully used for the purpose described in the loan application form. For example many first time loans are used to retire more expensive debt taken from local moneylenders ... and indeed from a purely economic perspective this is entirely rational on the part of the client.

The question is whether the emphasis on loan utilisation checks is entirely rational on the part of the MFI. The check may seek to prohibit entirely sensible use of loans for "non business" purposes that may have a much higher rate of return than the business purpose – for example retiring that expensive debt or buying medicine for a wage-earner in the household. Furthermore, the checks set the tone of the relationship between the borrower and the lender. Lending is essentially a relationship of trust. Loan utilisation checks force the client to lie and deceive in the very first interaction with the MFI after getting a loan. The client arranges a cow or buffalo from her neighbour to parade in front of the visiting credit officer or branch manager ... and very often the credit officers also know perfectly well that this is a charade and that the majority of the loan is being "diverted" for another purpose.

MORE COWS THAN PEOPLE?

In Bangladesh, clients regularly use “cow fattening” as their standard “purpose of loan” on the loan application form. The activity is acceptable to MFIs’ management, most households have cows, and these can be displayed in the unlikely event that the lending institution’s loan officers care or come to check up on the use of the loan. But few loan officers are interested, and the (almost entirely fictitious) data is effectively being collected for the benefit of the MFI’s Annual Reports (see Todd, 1996¹). Typically, each year MFIs report around 15-50% of loans being used for cow fattening/milk production. With nearly 18 million borrowers in Bangladesh, many of who have been involved in MFI programmes for more than five years, cows should now significantly out-number people!

In many countries, given poor people’s remarkable commitment to education, it is not surprising that loans ear-marked solely for agriculture are (in part at least) diverted to finance schooling costs. It is for this reason that successful microfinance institutions world-wide do not tie their loans to specific types of projects; and where their policies insist on providing their general loans only for “productive” purposes, almost invariably have a mechanism to provide credit facilities (typically short duration emergency loans) to meet providential needs, or simply turn a “blind-eye”.

In many respects, it is difficult to understand why MFIs really care about how their clients use their loans – they are lending against future household income flows, which are typically many multiples of the amount lent by the MFIs in their conservative, initial loan cycles. When MFIs are making small loans, they are helping their clients’ households to diversify sources of income, to reduce the risk when one of the household income sources fails and to smooth seasonal troughs in income availability. Most businesses enjoy their highest sales during the festival seasons, yet school fees and other expenses are tied to the school calendar. For this reason it is not uncommon to find a household diversifying to run several lines of business that have varying levels of cash-flow at different times of the year and in different trades.

LOANS AS ADVANCES AGAINST SAVINGS FROM HOUSEHOLD INCOME

When Parvati bought the buffalo calf with her first loan, she knew it would be a struggle. Not only would she have to find the Rs.160 for the weekly repayments, but also she would have to buy food for the calf so that it grew and fattened quickly. But by taking a little more care with the meagre household budget, and selling the eggs from their few chickens, she felt that she could manage.

Siddiqua was confident that, if by the grace of Allah, her husband was well enough to continue his work as a security guard throughout the year, she could pay off the loan she had used to buy jewellery for her daughter’s wedding, and a few sheets of corrugated iron to replace the leaking thatch on their home. (Of course, she had told the Grameen Bank loan officer that she was using the loan for “paddy husking” to keep him happy).

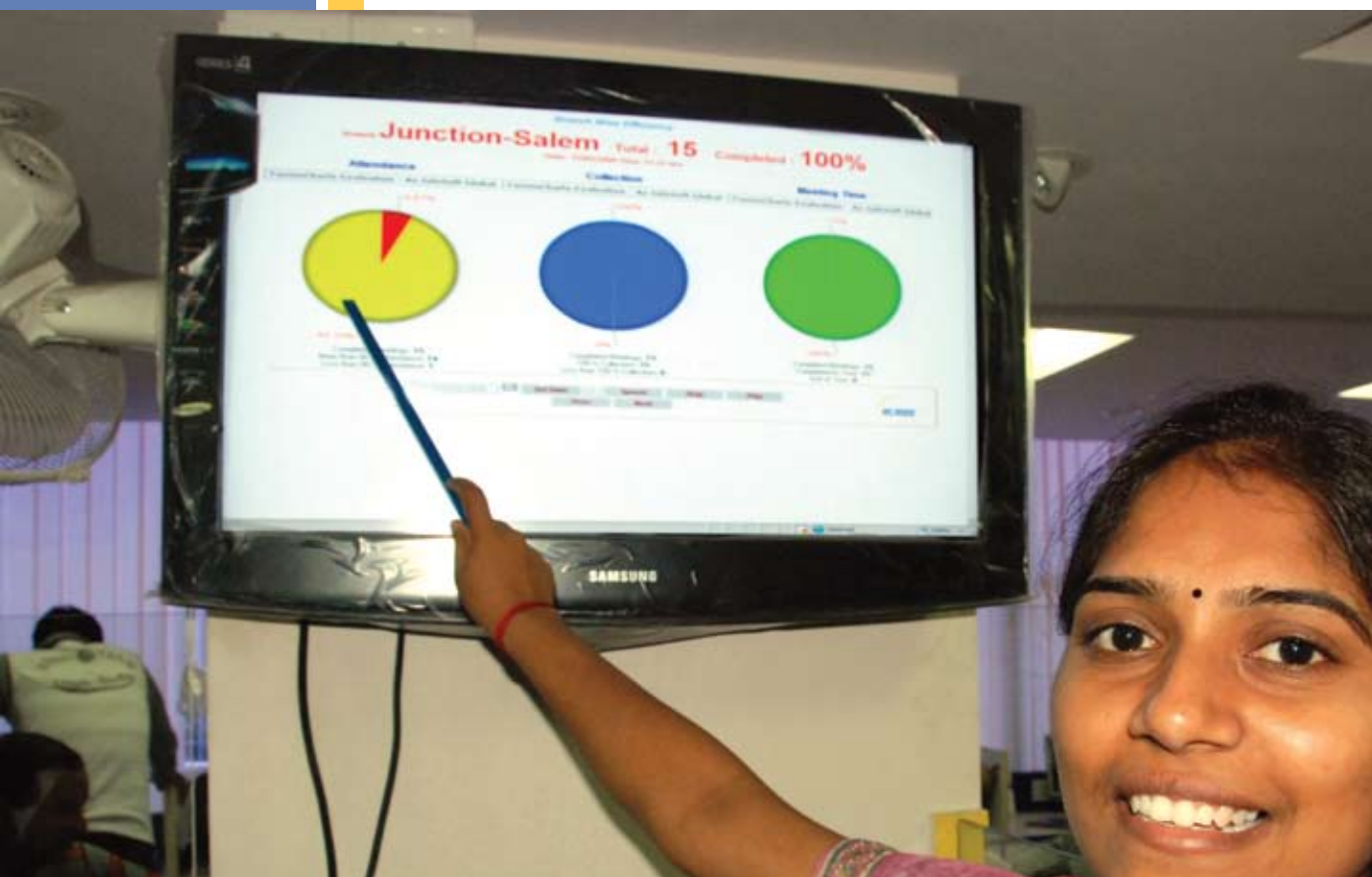
Parvati and Siddiqua share one thing in common with millions of other MFI members throughout the world, they are making their weekly loan repayments not from income arising from the loan, but from the normal family household income. This pattern is extremely common not least of all because of the typical MFI repayment schedules. These schedules normally require weekly instalments (no grace period), and thus require investments that generate an immediate and rapid rate of return if repayments are to be made from the enterprise’s income. Therefore, savings from other sources of household income are often, if not usually, the primary source of the money used to make loan repayments.

¹Todd, H. “Woman At The Center: Grameen Bank After One Decade”, University Press Limited, Dhaka, 1996.

However, loan utilisation checks are extremely important for larger individual, enterprise development loans. These loans are larger in size and sanctioned on the basis of the credit officers' assessment of the cash flow of that particular business. It therefore becomes much more important to ensure that the capital is indeed invested in the business and used for the purpose outlined in the loan document, which in turn increases the cashflow from that business.

MARKET STRATEGY DEVELOPMENT AND 3RD GENERATION MICROFINANCE IN INDIA

Anant Jayant Natu



INTRODUCTION

Microfinance in India has evolved over the past two decades since its inception in early 1990s. The SHG-bank linkage model, its first prototype, was an offspring from an unlikely marriage between the social intermediation role of the civil society and the financial intermediation of banks, with RBI and NABARD acting as more than willing midwives.

As the business potential of microfinance dawned on many, microfinance institutions (MFIs) took on the task of both the social and financial intermediation. Thus an alternate channel for microfinance arrived (somewhat belatedly by comparison to elsewhere in the world). This was second generation microfinance for India. Most of the MFIs adopted the Joint Liability Groups (JLGs) methodology and standardisation became the new mantra for achieving rapid growth. Over the past 2-3 years, NBFC-MFIs operating under predominantly JLG-based methodology have emerged as a significant and rapidly growing force.

Nonetheless, SHG-based systems still serve three quarters of the overall microfinance clients in India and have two-thirds of the total loan outstanding¹. Some would argue that SHG-based models are still the most relevant model for certain segments of India's poor. Nonetheless, there is growing evidence of significant problems with SHG-based models' portfolios², and some issues within those of JLG-based MFIs, particularly in competitive areas of the country. With competition comes change.

THE CHANGING ENVIRONMENT - A TECTONIC SHIFT?

Interestingly, the formal, public sector financial institutions (Regional Rural Banks, Cooperative Banks etc.) are still not competing in the microfinance market. But the burgeoning number of MFIs, and the relatively narrow focus of their products, has meant that intense competition has emerged, particularly in the southern states and in some limited areas of the east. This has provided microfinance borrowers with unprecedented access to credit. This has been a boon for them, but not without the concomitant vices of competition. Many of the larger MFIs are now responding to the demands of their commercial equity investors for very rapid expansion by adopting a "sales" driven approach for increasing outreach. The dash for growth has also seen several MFIs over-stretch their management capabilities and systems, resulting in significant portfolio problems.

In addition, there is growing evidence of clients "patching" loans together from several MFIs in order to meet their needs for finance. For example a high yield heifer costs around Rs.30,000 (USD \$600) – more than any one Indian MFI will lend under a traditional group-based system. The proliferation and massive growth of MFIs has meant that (so long as they are willing to sit in the groups each week) clients can access three (or more) loans from different MFIs. Unsurprisingly, while many clients successfully take multiple loans to finance larger projects, others become over indebted – this has led to growing signs of stress in MFIs' portfolios, most dramatically evidenced in Kolar district in Karnataka³.

To respond to the cut-throat competition MFIs are trying out different approaches that range from the desperate to the deliberate. The desperate measures have bordered on the unethical like "poaching" both credit officers and even groups from rival MFIs. Other more deliberate attempts have included offering individual lending (IL) product to their old clients⁴. But the design of many MFIs' IL product is little different from their group loans – except that group guarantee is replaced by a single guarantor.

¹"Bharat Microfinance Report: Quick Data-2009", Sa-Dhan

²See *MicroSave* India Focus Note # 15 "Delinquency in Self Help Groups"

³See *MicroSave* India Focus Note # 25 "Dinosaurs and Rabbits"

⁴6 of the top 50 MFIs in India are offering IL product. Refer "India Top 50 Microfinance Institutions; October 2009; CRISIL ratings

Basic evaluation of the enterprise is usually performed, but the product is rarely customised to respond to cash flows, or even the financing needs, but rather reflects a pre-defined stepped loan schedule. And few MFIs invest in the skill sets required for a successful IL programme⁵.

In being “reactive” to the competition (and in some cases their private equity investors), many MFIs are losing sight of the *raison d’être* of their existence - their clients. It is increasingly clear that the challenges of competition must be countered by bringing client back as the “focus” of their business. This shift in focus will bring a “tectonic” change in the way MFIs do microfinance and see the emergence of 3rd Generation microfinance institutions (3G-MFIs).

3G MICROFINANCE INSTITUTIONS: “EXPANSION” TO “ENGAGEMENT”

A 3G-MFI is continually asking itself one basic question: “What share of my client’s financial needs is being met by us?” It will seek to be a “one-stop-shop” for all her financial needs in manner that “delights” her. The very mission of the 3G-MFI sets it apart from its competitors, as it no longer treats its client as a headcount, but as an individual with dynamic needs.

One distinct feature of any 3G-MFI is their long term market strategy. They consciously choose to pursue the strategy of product modification and new product development over market penetration and geographic expansion. This shift of strategy from “Expansion” to “Engagement” is shown in the figure below⁶.

		PRODUCT		
		Existing	Modified	New
M A R K E T	Existing	Sell more of our existing products to our existing customers (Market penetration)	Modify our current products and sell more of them to our existing customers (Product modification)	Design new products that will appeal to our existing customers (New product development)
	Modified	Enter and sell our products in other geographic areas (Geographic expansion)	Offer and sell modified products to new geographical markets.	Design new products for prospects in new geographic areas.
	New	Sell our existing products to new types of customers (Segment invasion)	Offer and sell modified products to new types of customers	Design new products to sell to new customers (Diversification)

3G-MFIs will see the growth in terms of improvements in their clients’ financial well-being, and the MFIs’ ability to serve them over a long time. Some MFIs are even looking at using full life time value of customer analysis as a basis of their planning. 3G-MFIs will also grow horizontally, but this will not be their dominant strategy; and they will grow horizontally only to an extent that does not compromise their engagement with existing client segments.

⁵See *MicroSave* India Focus Note 14 “Challenges of Introducing Individual Lending in India” and *MicroSave* India Focus Note 34 “Risks and Challenges in Individual Lending”

⁶Based on the ‘Kotler on Marketing: How to Create Win and Dominate Markets’

3G-MFIs: HOW WILL THEY DO IT?

3G-MFI will operationalise the strategy of deepening engagement by:

1. Offering clients a suite of financial services in response to their full spectrum of financial needs – credit, savings, remittances, insurance etc.
2. Focusing on convenience for all clients – so that products respond to clients’ needs, and not just those of the institution.
3. Leverage technology, particularly e-/m-banking to increase transaction efficiency and reduce costs.
4. Add supplementary services, such as the “livelihood” services or education/food security services⁷ or possibly even health services.

One of the pioneers of 3rd generation microfinance has been the IFMR Trust Holdings, which provides “Wealth Management” support to its clients. Wealth management is a notion that transcends product-centric thinking and the traditional focus on outreach alone. The wealth management perspective calls for institutions that are embedded within the community and growing vertically rather than horizontally. It means they will serve a limited set of clients in a more comprehensive manner, rather than be spread across a large number of clients across geographies. It also means that the institution offers its services to all people in the communities it serves⁸.

CHALLENGES FOR 3G-MFI

Since 3G-MFIs look at microfinance from a different perspective; they need do things differently from other MFIs, specifically:

1. Train the front-line staff intensively for them to be able to provide “wealth management” advice.
2. Offer savings services through Money Market Mutual Funds or other collaborations.
3. Tie up with other institutions to provide tailored remittances, insurance, pensions and other products and services.
4. Optimise the use of technology to allow tie-ups and reduce time spent on processing and back-end operations.

CONCLUSION

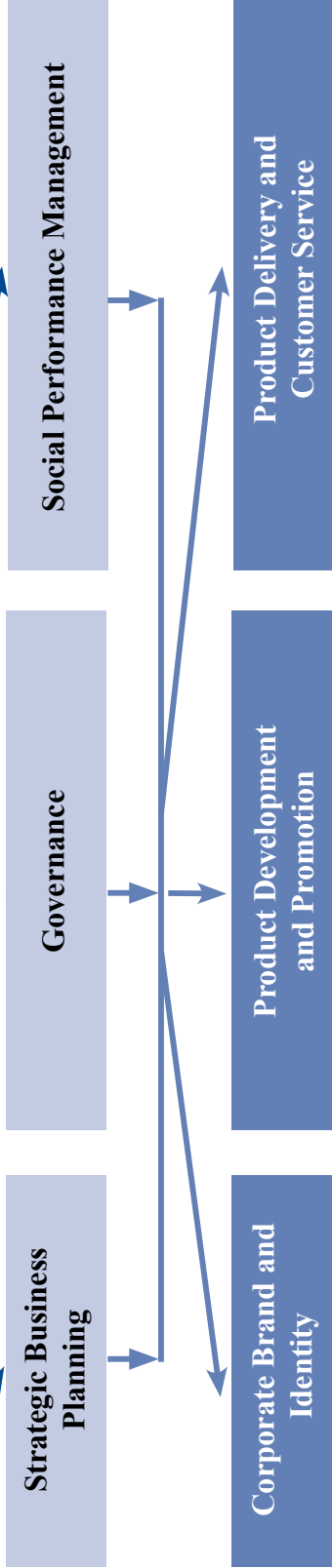
Given the saturation in a growing number of geographic markets, it is imperative for the MFIs to shift from a “product centric” to a “client centric” approach. The product-centric approach worked in uncompetitive markets with a huge demand-supply gap, and when the imperative was for rapid expansion. But as the number and outreach of MFIs has grown, supply is no more a constraint in many regions.

Clients are in a position to pick-and-choose the MFI that offers them the most value. The 3G-MFIs will be quick to sense this “tectonic shift” in the dynamics of the highly competitive markets, and do everything they can to put the client back at the centre of their business. This focus will translate into a respect for client’s time and dignity, and into making the entire spectrum of financial services for her livelihood available to her – a welcome prospect for both clients and those who believe in microfinance as a service for development and poverty eradication.

⁷Equitas is building in such services

⁸IFMR Trust Synthesis Newsletter August 2009

INSTITUTIONAL DEVELOPMENT



Tier 1
Strategies

Tier 2
Strategies

- Market Research for Micro Finance
- Strategic Marketing for MFIs
- Product Marketing
- Corporate Brand and Identity
- Customer Services for Financial Institutions
- Process Mapping
- Capital Structuring & Equity Valuation

- Market Research for MicroFinance
- Quantitative Market Research Methods
- Costing and Pricing of Financial Services
- Process Mapping
- Institutional and Product Development
- Risk Analysis
- Individual Lending for Managers
- Individual Lending for Credit Officers
- Planning, Conducting and Monitoring
- Pilot Tests: Savings Products
- Planning, Conducting and Monitoring
- Pilot Tests: Loan Products
- Product Roll-Out

- Market Research for MicroFinance
- Customer Services for Financial Institutions
- Process Mapping
- Loan Portfolio Audit
- Internal Audit & Controls
- Financial and Accounting Systems
- Financial Management and Ratio Analysis
- Advanced Accounting for MFIs
- Management Information Systems for MFIs
- Delinquency Management for Group-based MFIs
- Human Resource Management
- Designing and Implementing Staff Incentive Schemes
- Training of Trainers
- Branch Managers' Training

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