MicroSave Briefing Note # 88

Breaking the Barriers: Market Expansion through Micro and Small Enterprises Lending

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Background

Introducing micro and small enterprises lending (MSEL) 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 MSEL 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 MSEL, the target clientele and challenges MFIs need to consider in developing the product. Experienced MFIs introducing MSEL 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 MSEL as an addition to their group lending programmes. Some distinct features of MSEL 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 MSEL as the appraisal, substantially conducted by group members in group lending, is entirely conducted by the credit officer.
- MSEL is often developed specifically for certain target customer segments, like well-established shopkeepers, 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 MSEL and to manage delinquency.
- MSEL 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 Micro and small enterprises 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:
  - Attending group meetings requires time that established entrepreneurs may no longer be able to spare given their growing businesses.
  - 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.
  - Mature members may have accumulated, or may be seeking loans to acquire, physical assets that can secure the loans.
  - 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.
  - 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.
  - 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***

  MSEL 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 MSEL 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. MSEL 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 MSEL 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 micro and small enterprises 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 micro and small enterprises loans.

Challenges in Targeting Group Clients[1]

Although the target client for MSEL differs from the typical group lending client, MFIs usually test the waters by first targeting their top end group clients for a new MSEL 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 MSEL, and an effective member replacement mechanism to sustain groups.
- JLG credit officers often discourage members from taking MSEL 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.
- MSEL 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 MSEL (ignoring the lower- or mid-level clients) as this raises questions of mission drift.

Challenge with Getting Funder Support for MSEL

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

Conclusion

> A large MFI working in the northern part of India developed an MSEL 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 MSEL delinquency levels experienced by a number of other MFIs that had started MSEL products without proper systems/processes and structures (and with pitfalls that "expert" consumer credit companies had fallen into). A great disservice to the cause!

Introducing MSEL 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.

[1] See *MicroSave* Briefing Note # 84 "Micro and small enterprises Lending for MFIs – Strategic Issues to Consider First"