MicroSave India Focus Note 34

Risks and Challenges in Individual Lending

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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 risks ensure 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. 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 of 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 systems[1].

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 implementation[2].

[1] Refer *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