MicroSave Briefing Note # 45

Microfinance Institutions and Salary Based Consumer Lending

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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

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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 is 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.

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