MicroSave Briefing Note # 58

Developing Cash Flow Based Individual Business Loans

The Experience of Equity Bank with Biashara Imara

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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 Succesful 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.