MicroSave Briefing Note # 84

Individual Lending for MFIs – Strategic Issues to Consider First

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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 planning[2], 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		

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

[1] See *MicroSave* Briefing Notes # 86 and # 87 on "Product Features of Individual Lending".
[2] See *MicroSave* Toolkit on "Strategic Business Planning for MFIs".

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 & 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 is 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 Competencies[3]
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.

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 Financing[4]
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, so 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.

[3] See *MicroSave* Briefing Note # 87 "Product Features of Individual Lending" (2/2).
[4] See *MicroSave* India Focus Note 14 "Challenges of Introducing IL in India" for more details on asset and cash flow-based financing.