MicroSave Briefing Note # 85

Managing Individual Lending

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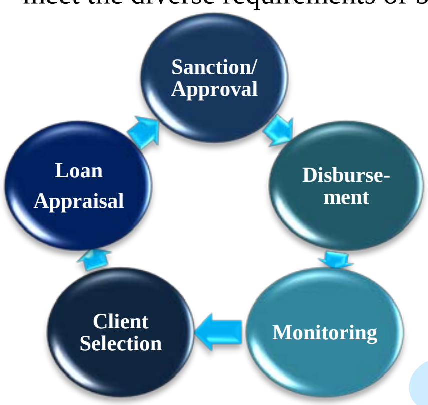
Introduction

For all the hype that surrounds it, individual lending (IL) by microfinance institutions (MFIs), still remains in its infancy in many markets. A major factor responsible for this is the relative inexperience of MFIs with such programmes. IL by its nature is market-led and needs to be heavily customised to suit local conditions.

Operationalising IL

Most MFIs implementing IL have a group-lending base, and are largely looking to meet their mature clients' needs for higher loans.[1] This means that their systems and procedures are primarily geared towards group lending, necessitating adapting these operational structures to the requirements of an IL product. MFIs intending to venture into IL should be very well aware of the need for customisation, and thus put in place adequate structures to meet the diverse requirements of both products.



It is critical to balance all the steps of the lending cycle, depicted in the chart to the left, to achieve successful lending. Inadequate focus on any of these steps will increase both credit and operational risks.

Client Selection[2]

Identifying the target client segment is the first step in setting up a successful IL programme. Most MFIs automatically consider their matured group loan clients as their primary target segment. While this might be the most convenient way to start with, it usually closes doors to significant opportunities for scaling-up … or indeed achieving critical mass as typically on around 20% of group members are real entrepreneurs needing larger scale financing. Expanding beyond group client graduation calls for a clear determination of who the target clients are and their needs. This is ideally done through thorough qualitative research, so as to direct the IL product design, marketing and communication efforts at the intended segment.

Loan Appraisal

Loan appraisal in group lending methodology is usually based on simple loan cycle-based incremental amount, dependence on social collateral (i.e. joint liability) and contingent renewal (denying repeat loans to a defaulter's colleagues) to mitigate risk. In IL the client's character/reputation, commitment to the enterprise and the assessed capacity to pay is paramount. Assessing potential borrowers requires a step by step approach as outlined below:

- ***Initial Screening***
  Even before accepting the individual loan applications, a first-level screening is highly recommended, entailing predefined criteria such as minimum experience in the business, house/shop ownership, bank account etc. For MFIs beginning to implement IL, the screening criteria can initially be basic, and then later be developed into an internal credit scoring mechanism as the lending scales up and data for a basic scoring design is accumulated. For the clients, efficient and objective initial screening ensures that any decline decision is obtained on their basic eligibility for the loan without unduly spending time and other resources.
- ***Field-level Verification***
  The credit officer must confirm the loan applicant's business activities and collect as much ground-level information as necessary to enable prudent credit decisions. In instances where a loan applicant does not maintain complete and reliable books of accounts, financial data for the cash flow analysis is usually estimated from proxies such as bills/confirmation from suppliers, physical stock verification etc. A credit officer should verify accuracy of information on the business situation and prospects provided by the client through other sources like customers, employees, suppliers and competitors, and his or her own understanding of the market and the dynamics of the client's type of business built over time.
- ***Cash Flow Analysis***
  For the cash flow analysis, the Credit Officer looks at the cash generated from the business and household by taking into account all the inflows and outflows so as to arrive at repayment capacity and loan amount that can be disbursed. It is important that the appraisal

[1] See *MicroSave* Briefing Notes # 86 and # 87 on "Product Features of Individual Lending".
[2] See *MicroSave* Briefing Note # 84 "Individual Lending for MFIs – Strategic Issues to Consider First" and *MicroSave* Briefing Note # 88 "Breaking the Barriers: Market Expansion through Individual Lending".

considers not just business cash flows (as some MFIs do), but household cash flows too, since business cash flow is not always entirely reinvested in the business, and may be partly consumed by the household. Conversely, net inflows from other household enterprises may increase the certainty of loan repayment. MFIs should take care not to raise any false expectations by training and sensitising staff on the specific aspects to be communicated. A section on the "Dos and Don'ts" in the operations manual will help the staff and the MFI to streamline and standardise communication.

> Credit officers of an MFI based in South India promised to provide larger repeat loans if clients repaid on time, but they failed to extend larger loans since loan amounts were dependent on current cash flows and not the clients' expected increased future cash flows. This led to widespread dissatisfaction among the clients.
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> A number of MFIs in Africa have experienced delinquency problems as a result of poor appraisals linked to overburdened credit officers, poorly managed credit officer transfers between branches and laxity in analysing repeat loans, all occurring more often during periods of high growth.

Loan Approval

Loan approvals should be conducted by a credit committee of no less than 3 members, typically including the branch manager. Many MFIs vest credit decisions in one person, often supervisors/branch managers, leaving room for errors and personal biases. Moreover, the credit committee also ensures skill and knowledge transfer and reduces the likelihood of fraudulent decisions. However, the credit committee members should be accorded adequate time to make loan decisions – without undue disbursement pressure. Clearly defined loan sanctioning authority should be distributed along the organisational hierarchy with higher level supervisors taking decisions on larger loan amounts. Credit committee guidelines should be provided to committee members to enable this process. Moreover, the committee discussions need to be recorded for reference.

> One MFI in India had a system whereby the loans could be approved by designated single signatories with different approving limits at the branches and the area offices. A much greater issue was that the person who appraised a loan was often the same person who approved it.
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> At another MFI in East Africa, the credit committee did not meet but rather conveyed loan applications between themselves resulting in numerous instances of a member merely "approving because another member had approved". Both cases resulted in poor decisions and substantial delinquency levels.
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> *MicroSave* reviews identified these problems, which were rectified with better processes and procedures, like loan approvals in credit committee meetings.

Loan Disbursement

During loan disbursement, it is essential to ensure that legally valid and completed documentation is prepared. For instance, some MFIs obtain post-dated cheques from the guarantor, which provides additional comfort to the lender. Unlike group lending operations where loans are often disbursed in the field, it is advisable to make in-branch disbursements for the larger amounts involved with IL. It should be noted that legal requirements play a key role in how the loan is disbursed. For instance, in India amounts above Rs.20,000 have to be disbursed using account payee cheques.

> Field interviews conducted in an Indian MFI revealed that loan processing was completed on a timely basis, but disbursement took too long due to the liquidity problems faced by the institution.
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> Another bank in Africa unnecessarily insisted on cumbersome central disbursement at Head Office despite its well established branch management structure and systems.
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> Both cases resulted in a significant negative impact on the image of their brands in the market.

Monitoring and Client Relationship Management

Although it can be lucrative, IL typically presents increased portfolio quality challenges. Regular client monitoring is vital to read the warning signals before a default occurs. Monitoring schedules should be instituted in advance with a preliminary focus of ensuring correct loan utilisation, regularly monitoring the changes in business and household financials (especially for larger loans), and reminding the borrower (and guarantor) of their obligations. Even if the client completes a loan cycle without any untoward incident, but the loan utilisation was not as agreed, this should be considered negatively when assessing any subsequent loan application. Regular interaction with clients and guarantors also helps in building the relationship, cross-selling other services, and reducing the chance of wilful default. Observations and feedback from monitoring visits should be documented and reviewed, and immediate remedial steps taken where necessary.

Conclusion

IL definitely has the potential to grow beyond its current status in Asia and Africa. MFIs need to recognise that IL should be considered as a value proposition on its own and develop the organisational structures and capacity needed to deliver the product. Finally, an important determinant of success in implementing IL is availability of adequate liquidity. Well designed steps of the IL cycle help MFIs to manage their IL and expand their outreach and portfolio successfully. However, without the necessary institutional capacity and a systematic product development process IL can also become an operational and financial nightmare.