MicroSave India Focus Note 7

Are Loan Utilisation Checks Really Necessary?

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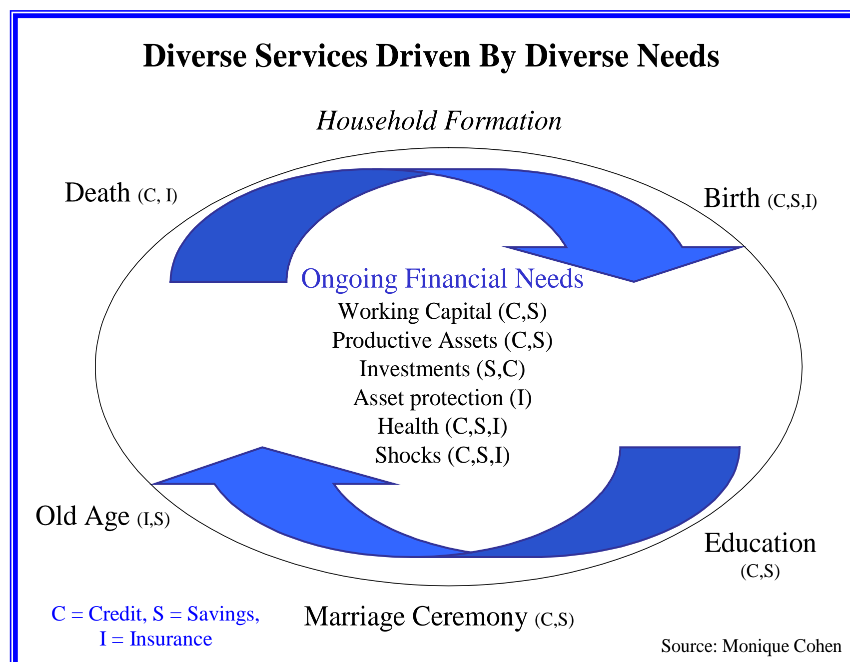
The microfinance industry has traditionally seen poor people's needs for financial services simply as "credit for enterprise". Today however, it is generally accepted that poor people also need access to lump-sums of money so that they can send their children to school; buy medicines; respond to other shocks and emergencies that beset their households; celebrate social and religious festivals; save up for old age etc. It is clear that poor people need a range of "financial services" not just the traditional, mono-product, working capital loan.



Thus, the typical 4-12 month working capital loan repayable in equal, immutable, weekly instalments does not adequately reflect the changing realities of poor households – whose income and expenditure flows can change significantly according to the season, the advent of festivals or shocks to the household economy. Low-income households need prompt access to emergency loans (a role played by family/friends or the informal sector moneylenders in most countries) or to increased flexibility in the repayment schedules set by financial institutions seeking to serve them.

As a result, traditional microcredit projects throughout the world have faced loan diversion: borrowers using their loans not for the purpose given on the loan application form or prescribed by the project, but for another more pressing purpose. Often loans are diverted for "providential" or "non-productive" purposes, to meet emergency medical or education expenses (both of which, incidentally, can also be seen, in the long run at least, as "productive"). But loans are also often diverted because the farmer sees another more viable or lucrative opportunity. Given that cash is "fungible" and the complexity of farmers' household economies, it is increasingly clear that trying to tie loans to specific uses without addressing other needs and opportunities is naïve at best.

Loan utilisation checks are an integral part of the original Grameen Bank methodology – and are viewed as essential by many MFIs in India. But if you ask almost any field officer, they will tell you (away from their supervisors) that the loans are not always, or even often, fully used for the purpose described in the loan application form. For example many first time loans are used to retire more expensive debt taken from local moneylenders … and indeed from a purely economic perspective this is entirely rational on the part of the client.

The question is whether the emphasis on loan utilisation checks is entirely rational on the part of the MFI. The check may seek to prohibit entirely sensible use of loans for "non business" purposes that may have a much higher rate of return than the business purpose – for example retiring that expensive debt or buying medicine for a wage-earner in the household. Furthermore, the checks set the tone of the relationship between the borrower and the lender. Lending is essentially a relationship of trust. Loan utilisation checks force the client to lie and deceive in the very first interaction with the MFI after getting a loan. The client arranges a cow or buffalo from her neighbour to parade in front of the visiting credit officer or branch manager … and very often the credit officers also know perfectly well that this is a charade and that the majority of the loan is being "diverted" for another purpose.

More Cows Than People?

In Bangladesh, clients regularly use "cow fattening" as their standard "purpose of loan" on the loan application form. The activity is acceptable to MFIs' management, most households have cows, and these can be displayed in the unlikely event that the lending institution's loan officers care or come to check up on the use of the loan. But few loan officers are interested, and the (almost entirely fictitious) data is effectively being collected for the benefit of the MFI's Annual Reports (see Todd, 1996[1]). Typically, each year MFIs report around 15-50% of loans being used for cow fattening/milk production. With nearly 18 million borrowers in Bangladesh, many of who have been involved in MFI programmes for more than five years, cows should now significantly out-number people!

In many countries, given poor people's remarkable commitment to education, it is not surprising that loans ear-marked solely for agriculture are (in part at least) diverted to finance schooling costs. It is for this reason that successful microfinance institutions world-wide do not tie their loans to specific types of projects; and where their policies insist on providing their general loans only for "productive" purposes, almost invariably have a mechanism to provide credit facilities (typically short duration emergency loans) to meet providential needs, or simply turn a "blind-eye".

In many respects, it is difficult to understand why MFIs really care about how their clients use their loans – they are lending against future household income flows, which are typically many multiples of the amount lent by the MFIs in their conservative, initial loan cycles. When MFIs are making small loans, they are helping their clients' households to diversify sources of income, to reduce the risk when one of the household income sources fails and to smooth seasonal troughs in income availability. Most businesses enjoy their highest sales during the festival seasons, yet school fees and other expenses are tied to the school calendar. For this reason it is not uncommon to find a household diversifying to run several lines of business that have varying levels of cash-flow at different times of the year and in different trades.

Loans As Advances Against Savings From Household Income

When Parvati bought the buffalo calf with her first loan, she knew it would be a struggle. Not only would she have to find the Rs.160 for the weekly repayments, but also she would have to buy food for the calf so that it grew and fattened quickly. But by taking a little more care with the meagre household budget, and selling the eggs from their few chickens, she felt that she could manage.

Siddiqua was confident that, if by the grace of Allah, her husband was well enough to continue his work as a security guard throughout the year, she could pay off the loan she had used to buy jewellery for her daughter's wedding, and a few sheets of corrugated iron to replace the leaking thatch on their home. (Of course, she had told the Grameen Bank loan officer that she was using the loan for "paddy husking" to keep him happy).

Parvati and Siddiqua share one thing in common with millions of other MFI members throughout the world, they are making their weekly loan repayments not from income arising from the loan, but from the normal family household income. This pattern is extremely common not least of all because of the typical MFI repayment schedules. These schedules normally require weekly instalments (no grace period), and thus require investments that generate an immediate and rapid rate of return if repayments are to be made from the enterprise's income. Therefore, savings from other sources of household income are often, if not usually, the primary source of the money used to make loan repayments.

However, loan utilisation checks <u>are</u> extremely important for larger individual, enterprise development loans. These loans are larger in size and sanctioned on the basis of the credit officers' assessment of the cash flow of that particular business. It therefore becomes much more important to ensure that the capital is indeed invested in the business and used for the purpose outlined in the loan document, which in turn increases the cashflow from that business.

[1] **Todd**, H. "Woman At The Center: Grameen Bank After One Decade", *University Press Limited*, Dhaka, 1996.