MicroSave India Focus Note 14

Challenges of Introducing Micro and Small Enterprise Lending in India

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Background

Indian microfinance institutions (MFIs) have more than a decade of experience with group lending methodologies and large indigenous institutions have emerged with group based products as the mainstay. However, Micro and Small Enterprise Lending (MSEL) is still in its infancy in the microfinance sector. While international experiences have offered valuable lessons to the Indian MFIs graduating to MSEL; it has to be recognised that the Indian market and the microfinance industry is somewhat different from their international counterparts that may have implemented MSEL successfully. Hence the lessons on EL need to be contextualised.

Cash-flow Based Lending

In India, as elsewhere, very few small business establishments have bills for purchases and sales. However, cash-flow based lending requires documented proof, or clear surrogates for information, collected from potential borrowers; or at least information that can be easily triangulated from neighbours or the community where the business is located. Accordingly, to assess the income from a business/household, surrogates like the volume of raw material (in the processing unit), stocks available (shops); family size (specifically number of earning versus non-earning members in the family); type of house and movable household assets (appliances etc.), have to be used. Since the usage of surrogates may be limited and cannot be uniform across markets, a thorough understanding of the local market and livelihood patterns is essential. Triangulation from neighbours can be effective only if the person who assesses the information is well aware of, but not biased towards (or against) the potential borrower. This might also lead to the same source of information for more than one potential borrower or one potential borrower being the source for triangulating information about another one.

Another constraint in cash-flow based lending is that third party guarantees, a prerequisite by most MFIs, may not always be feasible. Many Indian MFIs are also insisting on guarantees from Government employees, which necessarily limit the market size and may give rise to guarantors charging the borrowers for their services. However, post-dated cheques (PDCs) are backed by a strong legislation that allows the lender to proceed legally against the client, and can act as strong psychological collateral. However, getting a cheque book is difficult in many areas and/or with certain banks.

Assets as Collateral

Asset-backed lending requires clear legal documents establishing ownership of an asset to the borrower. In India, common household assets like land or a house is either owned jointly with other members of the family. Elsewhere across the globe, these issues are addressed by collateralising small scale productive (lathes, sewing machines etc.) and household (furniture, appliances etc.) assets. These assets are risky since they can be easily disposed by the borrower. However, more importantly, the realisation of collateral in India is simply not feasible … indeed any attempt to seize assets is likely to be met with a formal complaint to the police against the MFI for trespassing and theft – thus initiating a criminal case!

To address these issues, Indian MFIs could use a mix of different types of collateral, depending on the loan size – several Indian MFIs are already attempting this segmented approach. Two of the large MFIs from South India, use a mix (one or more) of the following:

- PDCs from the borrower (however in case of wilful default, the borrower can issue stop payment instructions!)
- Guarantee from a government employee (guarantor also should provide PDCs)
- Title Deed of any fixed asset (mortgage)
- Hypothecation of movable assets (say a tractor)

Operational Issues

One of the basic features of an Enterprise loan product is the need to tailor it to the needs of different clients and their businesses. This is a complete shift from the typical offerings of most MFIs which revolve around standardised group loans. Some Indian MFIs attempt to get over this problem by offering larger MSEL loans, which are nevertheless standardised, with an increasing loan size for each successful cycle. This approach divorces the amount sanctioned from the real financing need of the business – potentially compromising both the business and the loan itself. Loan structuring to suit the needs of the business is an important step in designing an MSEL product, and involves assessment of the business' cash flows and seasonal issues.

Cost considerations have forced group-lending MFIs to establish a modest branch infrastructure, which suits the operational model because clients rarely visit the branch office. However, in the case of MSEL, branch-based disbursements and/or repayments are necessary for a variety of reasons:

- Disbursements and repayments are Enterprise-specific and so the cost involved in transacting with each individual client separately in the field is high.
- Clients of this segment may demand flexibility in disbursement and repayment dates and times.
- Repayment amounts are generally higher and handling higher amounts of cash in the field is risky for the MFI and its staff.
- An MSEL programme is an exercise in relationship management, which calls for regular interaction and a more comfortable branch infrastructure.
- Larger loan amounts need to be disbursed through cheques (legal requirement as per Income Tax Act, for amounts of Rs.20,000 and above).

These operational issues necessitate better infrastructure and larger and relatively elegant branch offices close to the market area. Most Indian MFIs will need to establish separate branches for their MSEL operations. This necessarily means a significant increase in costs – both for infrastructure and also for routine operations.

Human Resources Issues

MSEL credit officers have to assess and evaluate businesses, identify the credit needs and structure loans accordingly. This requires them to be significantly more qualified than their group-based lending counterparts. Often recruitment of MSEL credit officers in the required numbers for work in semi-urban and rural areas is a challenging task. Most MFIs do not have the in house capacity to provide training on the skills necessary for MSEL. Unlike group lending, it is difficult for MSEL officers to learn skills "on-the job", because the loan sizes are higher, which results in enhanced credit risks. To initiate MSEL, MFIs are likely to need assistance from an external agency to train their staff … or to buy-in trained staff from other MFIs that have MSEL programmes.

Designing and integrating staff incentive systems for MSEL are also often challenging. Institutions offering both group and Enterprise loans face resistance from group lending credit officers, reluctant to let go of their good group-based clients.

Financial Management

Adding MSEL to the existing group lending portfolio often creates substantial demand for cash. Many MFIs do not plan their liquidity to respond to this increased demand. This increases the loan application to disbursement time for clients and thus creates a reputation risk.

In addition to increased infrastructure costs, the operational costs of an MSEL programme are also higher. Loan structuring, appraisal and monitoring involve resources of higher quality and quantity. Combining these with costs associated with delinquency (in terms of provisioning etc.), Enterprise lending becomes a costlier programme for the MFI - but of course this should be off-set by the larger loan size on which interest is being charged. To arrive at the pricing of the product on a rational basis, and operate efficiently, a costing exercise should be performed.

Management Information System (MIS)

A robust MIS is essential for an MSEL product – particularly if flexible repayments are to be accepted to reflect the borrower's business cycle. Most of the MIS applications being used by Indian MFIs are designed to handle standardised products, and lack scope for customisation to suit the needs of MSEL. MIS for MSEL must be able to capture the details of client's business and household assessment, generate repayment schedules for different amounts, different tenures (6 months, 12 months, 18 months and so on) and different cycles (monthly, fortnightly, weekly or lump sum repayment).

Conclusion

MSEL is a very different business as compared to group-based lending and presents challenges that need to be appreciated by MFIs in India. Across the world, MFIs are increasing the size and scope of their MSEL operations to respond to the demands of their graduating clients and offer services to the critical "missing middle". This trend is now beginning in India too, and MFIs should be aware of the challenges as well as opportunities presented by MSEL.