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The Risks of Discrepancy between MFIs' Product Design and Customers' Financial Requirements

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1. Introduction

- The concept of microfinance or microcredit was originated by Muhammad Yunus at Grameen Bank in Bangladesh in 1976.
- Microfinance started in Cambodian in early 1990s as non-profit entities with social missions to provide financial supports the bottom pyramid.
- Rapid development and commercialization of the sector took place in late 1990s and early 2000s.
- Concerns over rapid growth of microfinance sector:
  - Liquidity risks: sudden withdrawal of borrowings or deposit
  - Structural risks: interactions among institutions
  - Hyper competition risks: loosening assessment criteria
  - Product design risks: more complex customer base with diverse financial requirements.

1. Introduction

- Research Questions:
  - What are the mismatches between MFIs' product designs and customers' financial requirements and their associated risks?
  - How can these risks be mitigated?
- Research Objectives:
  - To evaluate MFIs' loan product designs in matching customers' financial requirements
  - To determine risk factors resulted from the mismatches between MFIs' loan product designs and customers' financial requirements
  - To indicate mechanism and initiatives in tackling these mismatches and reducing risks

2. Literature Review

- Definitions:
  - **Product**: anything that can be offered to a market for attention, acquisition, use, or consumption that might satisfy a want or need.
  - **Service**: an activity, benefit, or satisfaction offered for sale that is essentially intangible and does not result in ownership of anything.
- Loan has the characteristics of both product and service.
- Loan product, loan service, and credit product are used interchangeably; and all referred to business loan products (productive loans).

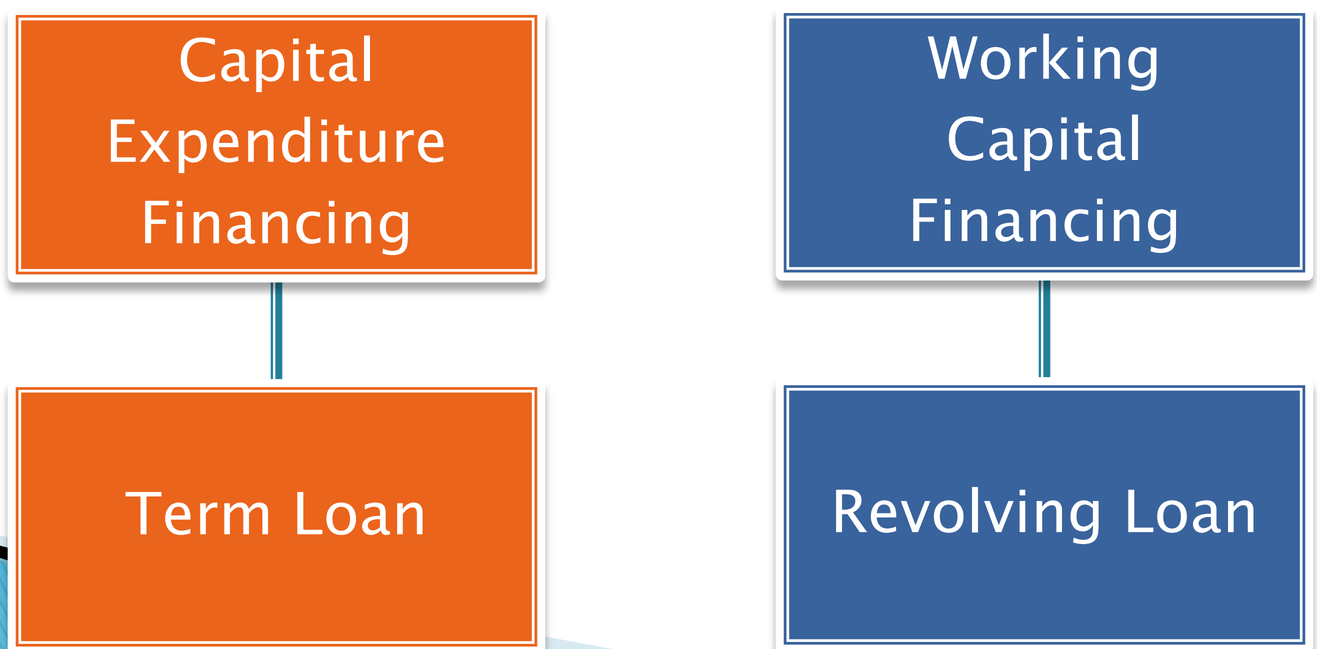
2. Literature Review

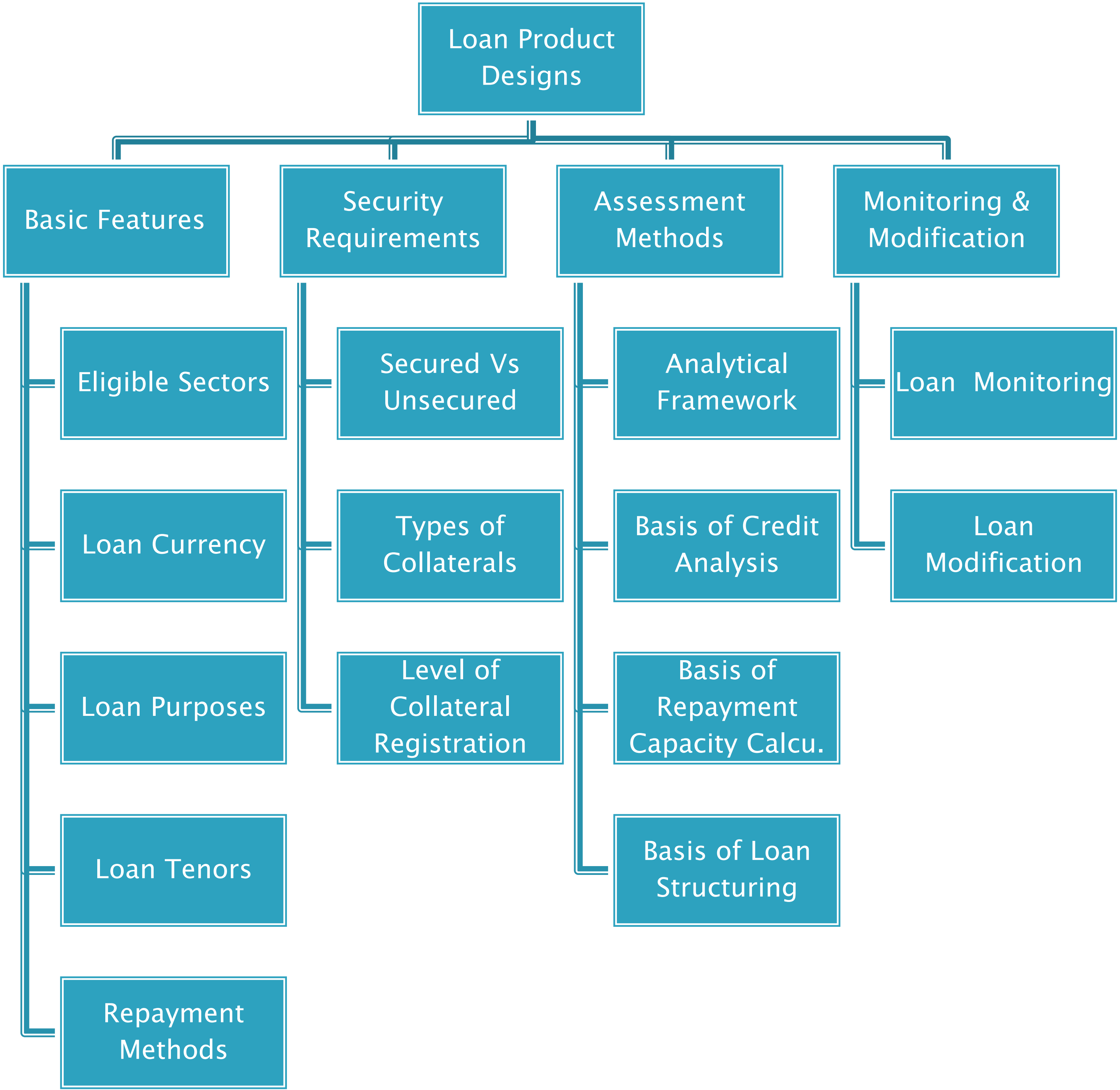
- Types of loan products:
  - Project financing
  - Object financing
  - Commodities financing
  - Income-producing real estate loan
  - High volatility commercial real estate loan

- These loan types can be grouped into two main types:
  - **Term Lending**: loan that is repaid in regular payments over a set period of time, and the repaid portion cannot be re-used again immediately.
  - **Revolving Loan**: loan that can be withdrawn, repaid, and redrawn again in any manner and any number of times, until the arrangement expires.

2. Literature Review

- **<u>Working capital financing</u>**: the funding of a business's current assets, such as inventory, receivables, other supplies – etc.
- **<u>Capital expenditure financing</u>**: the funding of a business's non-current assets, such as motor vehicle, machinery, warehouse – etc.




Loan Product Designs
Basic Features
Security Requirements
Assessment Methods
Monitoring & Modification
Eligible Sectors
Loan Currency
Loan Purposes
Loan Tenors
Repayment Methods
Secured Vs Unsecured
Types of Collaterals
Level of Collateral Registration
Analytical Framework
Basis of Credit Analysis
Basis of Repayment Capacity Calcu.
Basis of Loan Structuring
Loan Monitoring
Loan Modification

4. Research Methodology

Research Purpose:	Explanatory
Type of Data:	Primary Data
Data Collection:	Questionnaires & Interview
Sample:	6 MFIs (all MDIs)
Profile of Interviewees:	Senior Management
Structure of Data:	Six Sections

- Basic information of MFIs
- Basic loan product features
- Security requirements
- Assessment methods
- Loan monitoring and modification
- Ongoing improvement

5. Findings and Discussions

Basic Features

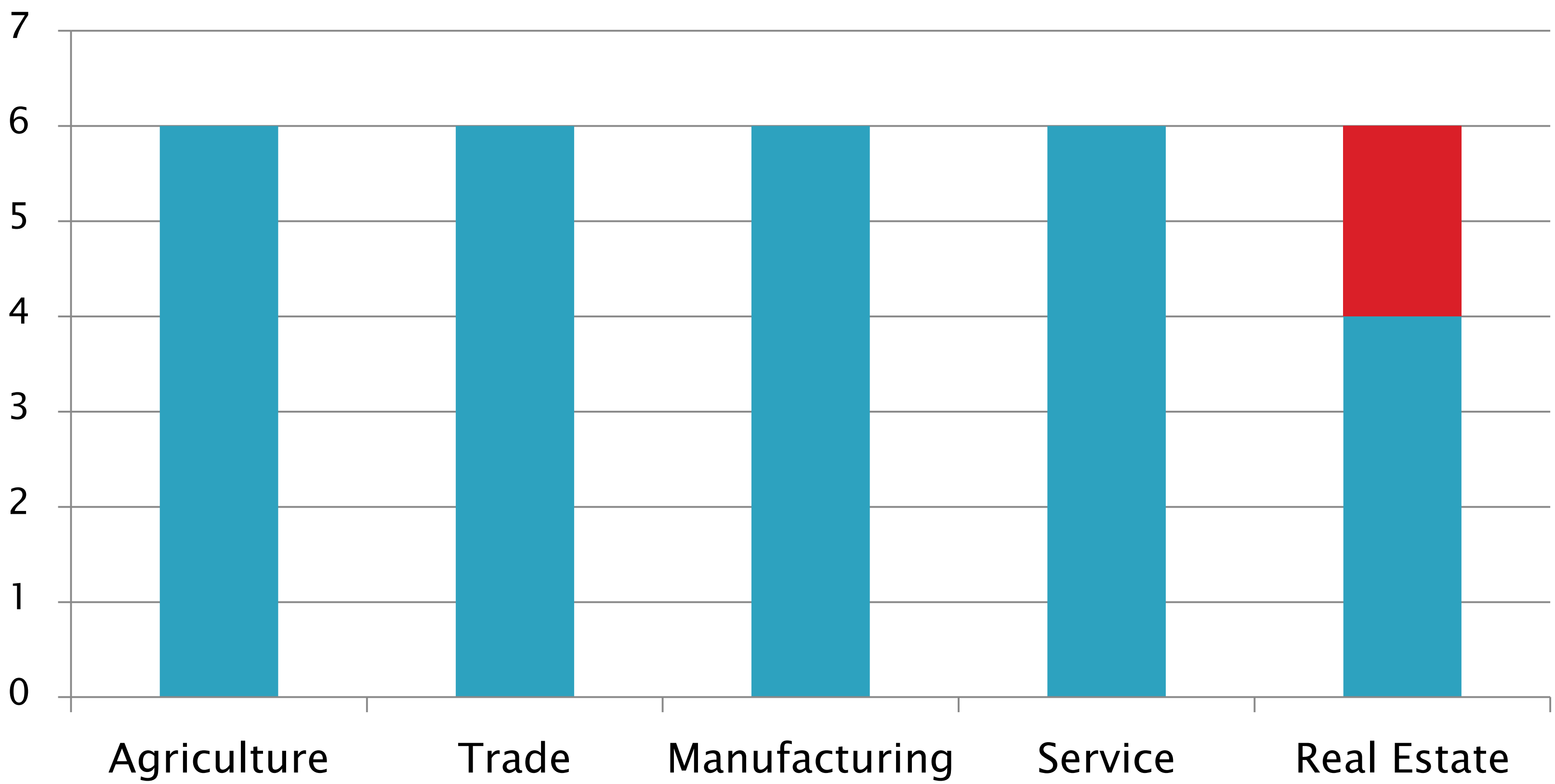
Security Requirements

Assessment Methods

Monitoring & Modification

5.1. Basic Features

5.1.1. Eligible Sectors:



5.1. Basic Features

5.1.2. Loan Currencies

MFI	KHR	USD	THB
1	√	√	√
2	√	√	√
3	√	√	√
4	√	√	√
5	√	√	√
6	√	√	√

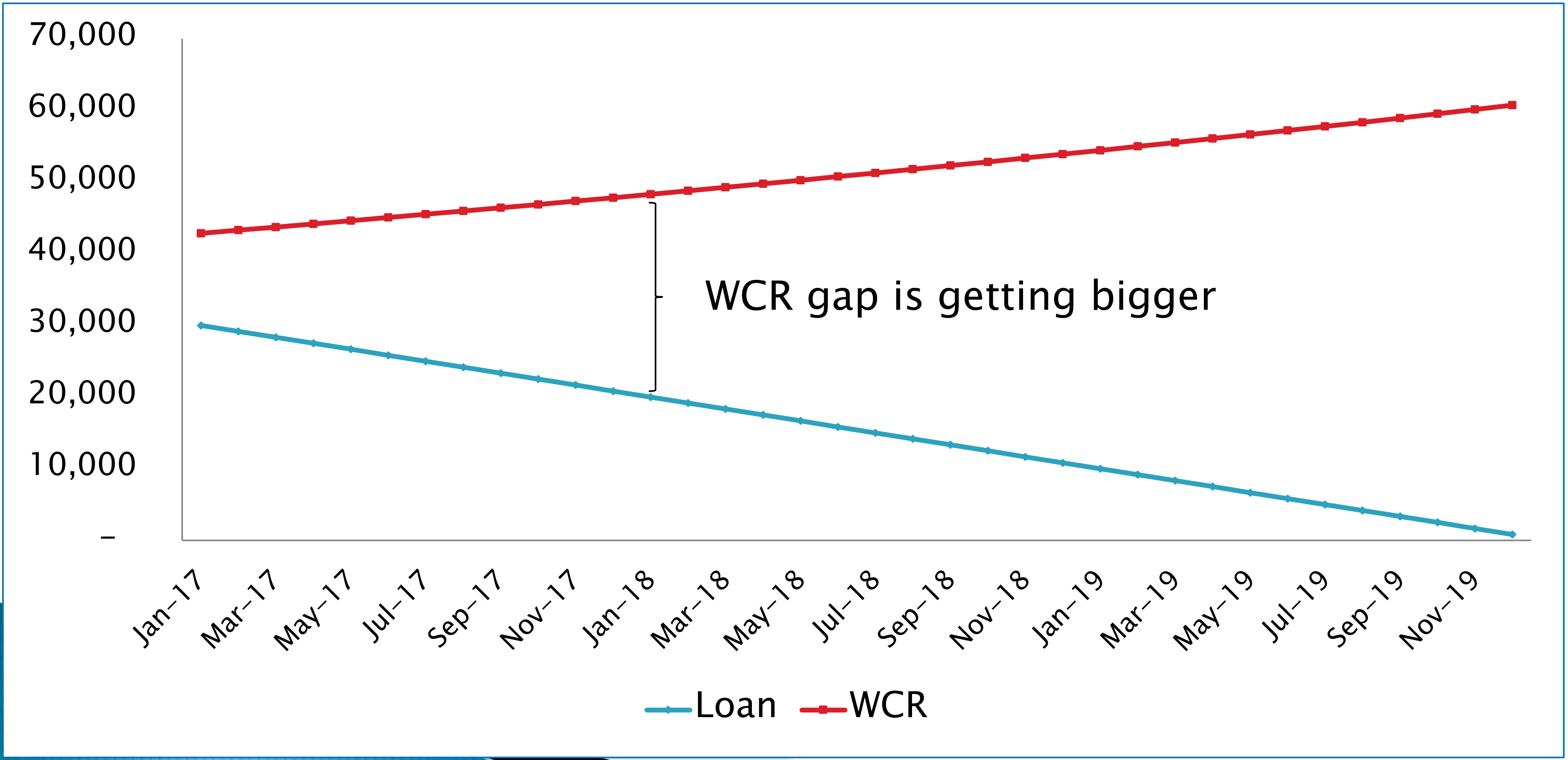
5.1. Basic Features

5.1.3. Loan Purpose

MFI	Working Capital Financing	Capital Expenditure Financing
1	√	√
2	√	√
3	√	√
4	√	√
5	√	√
6	√	√

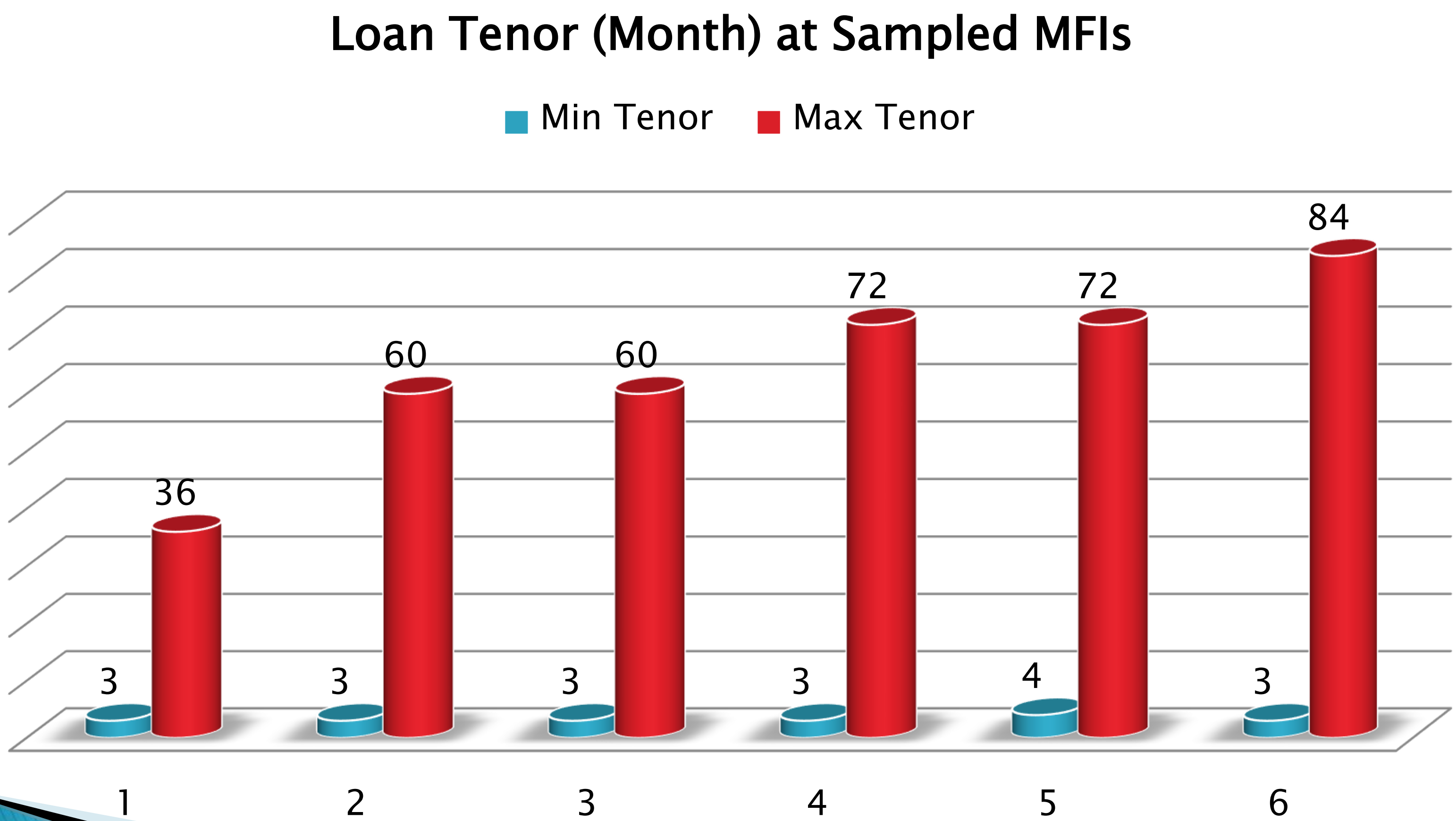
Mismatches/Risks: using mono-product for all purposes, which is Term Loan.

- Example:
  - A term loan of USD30,000 with tenor of 36 months is used to finance WCR of a business.
  - Just after 12 months, borrower loses 33.33% of available loan to finance its WCR.



5.1. Basic Features

5.1.4. Loan Tenor

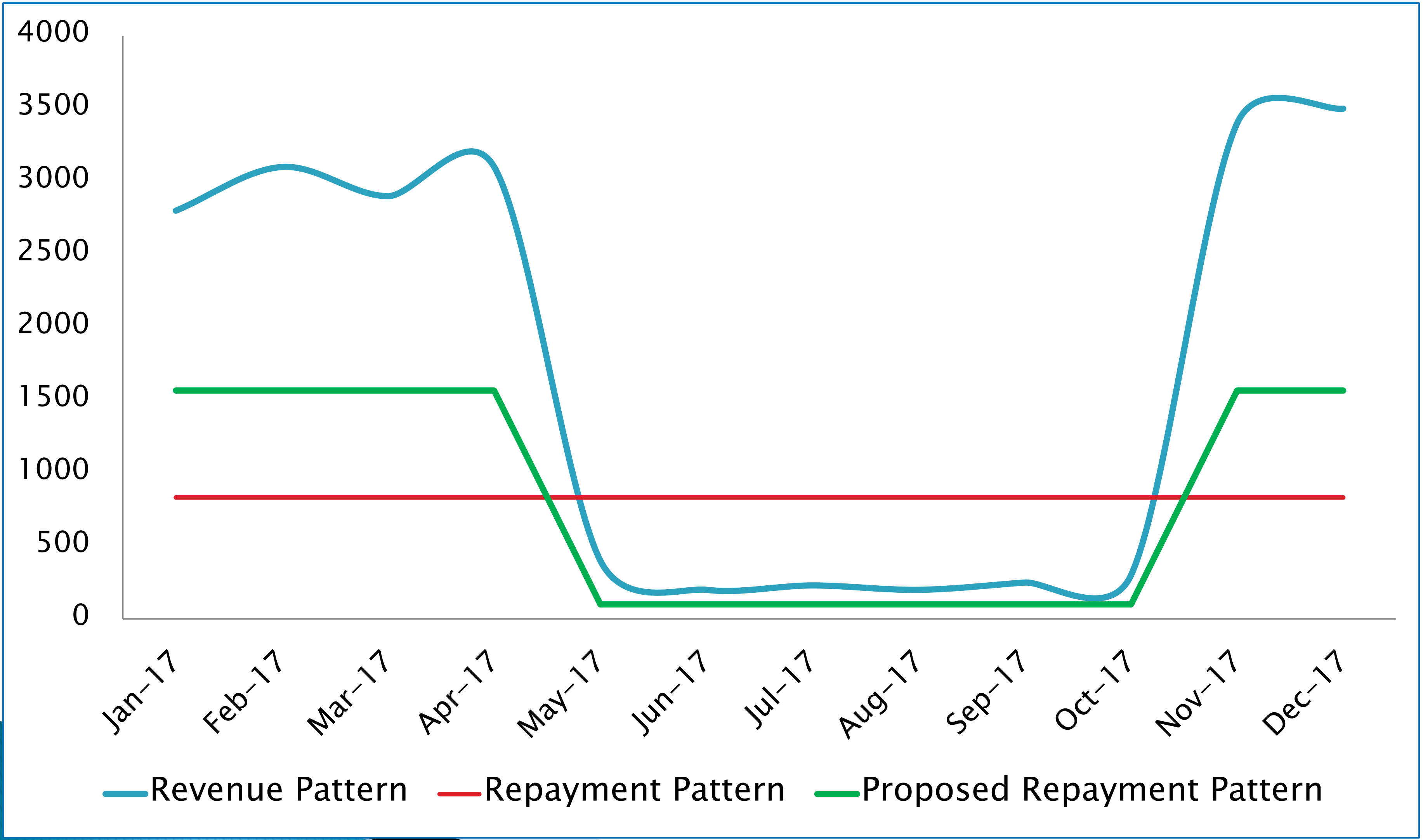


5.1. Basic Features

5.1.5. Repayment Methods:

MFI	Equated Principal Repayment	Equated Total Repayment	Seasonal Repayment	Bullet Repayment
1	√	√	√	√
2	√	√	√	√
3	√	√	√	√
4	√	√	√	X
5	√	√	√	X
6	√	X	X	X

- **Risks/Mismatches**: cannot satisfy different cash flow patterns of the borrowers.



5.2. Security Requirements

5.2.1. Secured Vs. Unsecured

- All participated MFIs only offer secured biz loans, citing the motives as below:
  - ✓ Unreliable financial data for accurate analysis
  - ✓ Psychological stimulus for strong repayment
  - ✓ Stronger recovery upon default
- Maximum Loan-to-Value ratio is 66.7%.
- **Mismatches/Risks**: credit analysis tends to focus more on collateral, not cash flow of the borrower.

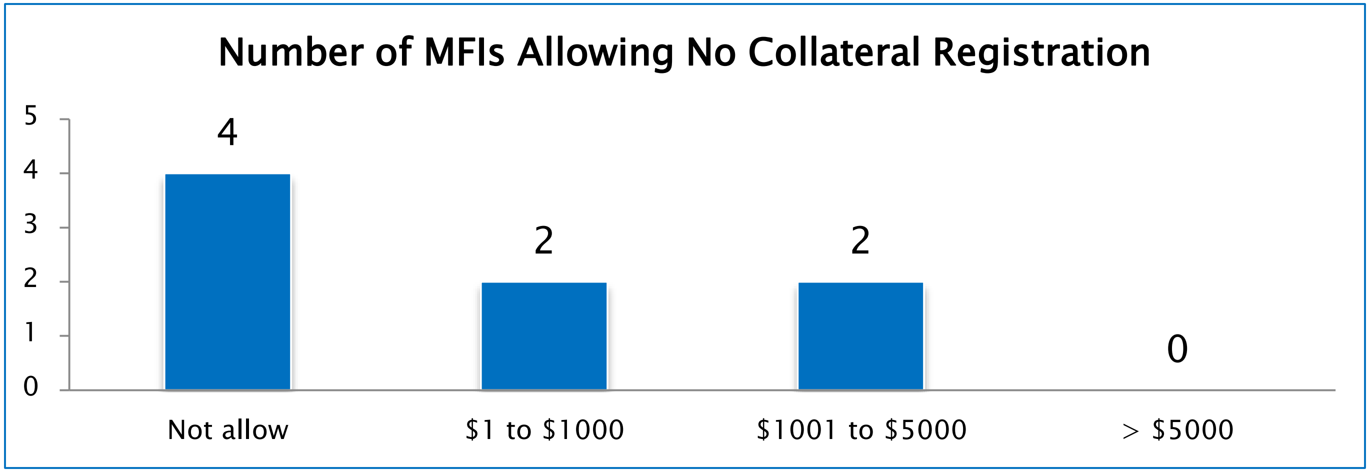
5.2. Security Requirements

5.2.2. Types of Collateral:

- Only landed properties (both soft and hard title) are accepted as primary collateral.
- Moveable assets are only considered as optional collateral, with no extension value.
- Motives (all sampled MFIs):
  - ✓ Difficult to evaluate and monitor.
  - ✓ Prevalence of informal market.
- **Mismatches/Risks**: no or little consideration over moveable assets; thus lead to shallow assessment.

5.2. Security Requirements

5.2.3. Level of Collateral Registration

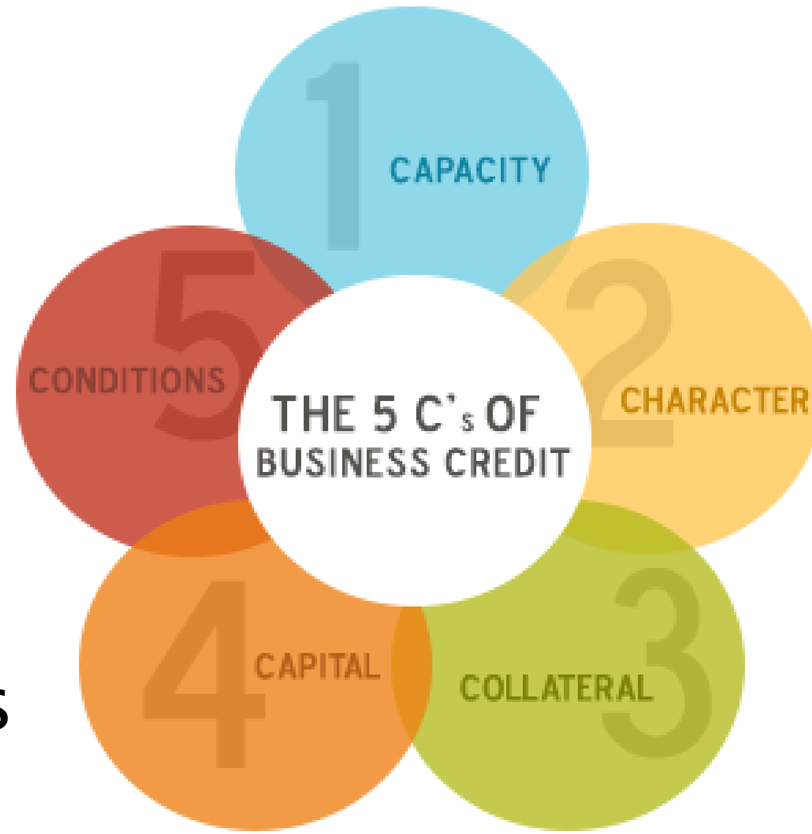


- Motives (all sampled MFIs):
  - ✓ Fast and convenient service.
  - ✓ Reduce cost of borrowings.
- **Mismatches/Risks**: legal validity of collateral pledge and/or difficulty in workout process.

5.3. Assessment Methods

5.3.1. Analytical Framework

- Different emphases
- Depend on quality of collected info
- Depend on capacity of credit operators
- Reflection of business model of MFIs



5.3. Assessment Methods

5.3.2. Basis of Credit Analysis

- 5 out 6 sampled MFIs use snapshot financials for credit assessment, with little track records.
- Cash inflow and cash outflow are not properly forecasted.
- Only 1 out 6 conducts monthly financial projection of the borrowers to assess cash flow pattern.
- **Mismatches/Risks**: little analysis on historical business and financial performance.

5.3. Assessment Methods

5.3.3. Basis of Repayment Capacity Calculation

- Profit-based calculation (Net profit, EBITDA…)
- Cash-flow-based calculation (NCAO, CFADS…)

All participated MFIs adopts profit-based calculation.

No or little consideration on cash flow of the business which make repayment capacity distorted.

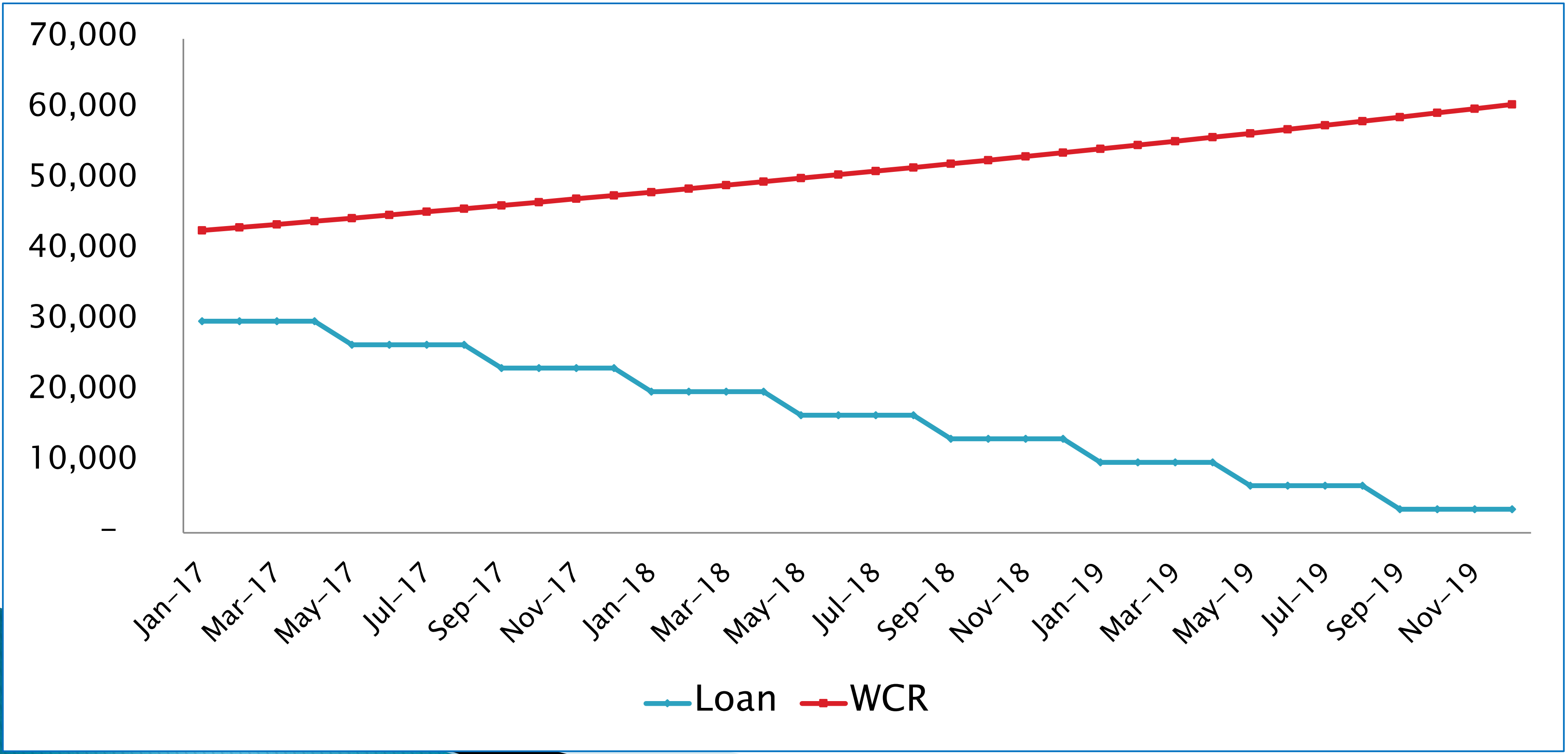
Mismatches/Risks: not suitable for analyzing repayment capacity of borrowers using working capital loan.

5.3. Assessment Methods

5.3.4. Basis of Loan Structuring

- Offering monotonous loan products, one-size-fit-all loan structuring method.
- Use the same loan types (term loan) for working capital financing and capital expenditure financing
- **Mismatches/Risks**: cannot satisfy different financial requirements of the borrowers.
- MFIs respond to this issue by:
  - Develop hybrid product: term loan with seasonal repayment
  - Develop revolving loan: such as overdraft

- Example:
  - A term loan of USD30,000 with tenor of 36 months is used to finance WCR of a business.
  - Just after 12 months, borrower STILL loses 33.33% of loan available to finance its WCR.



5.4. Monitoring & Modification

5.4.1. Loan Monitoring

MFI	1	2	3	4	5	6
Monthly					√	
Quarterly	√	√		√		
Semi-Annually						
Annually			√			
One-Off						√

Mismatches/Risks: frequency is one thing but the quality of monitoring is another important aspect.

5.4. Monitoring & Modification

5.4.2. Loan Modification

- Increasing Loan Size:
    1). Pay off existing loan and acquire larger loan
    2). Refinance existing loan
    3). Offer additional loan (another loan account)

- Paying off: partial or full

- Loan Restructuring:
  - Is allowed for force-majeure events
  - Is allowed for accident and/or robbery

Summary of Findings & Discussions

- Key risks/mismatches of MFIs' loan product designs:

Features	Mismatches/Risks
Loan purposes	Monotonous product for different financial requirements
Repayment modes	Cannot satisfy different cash flow patterns of borrowers
Security requirements	Stringent requirements on collateral, tend to focus more on assets than cash flow.
Types of collateral	Only landed property is accepted. Limiting SMEs in getting access to finance.
Level of collateral registration	No proper collateral registration induce legal validity of loan contract enforcement

Summary of Findings & Discussions

Features	Mismatches/Risks
Basis of credit analysis	Using snapshot financial statement with little or no historical record/data
Basis of repayment capacity calculation	Using profit-based calculation, which is on accrual basis
Basis of loan structuring	Limited loan product options, using one-size-fit-all loan product.
Increasing loan amount	Requiring borrowers to pay off existing loan to get bigger loan; leading to unclear credit assessment and inaccurate loan portfolio records
Loan restructuring	Pushing clients too hard since restructuring is only allowed for force-majeure and/or critical incidents.

6. Recommendations (and Challenges)

1. Offer variety of loan products to meet different financial needs of borrowers.
   - Unclear regulatory framework for MFIs to develop new products, particularly revolving loan
   - Capacity of product development team at MFIs

2. Review collateral requirements and consider taking moveable as core collateral.
   - Difficulty in evaluating & monitoring moveable collateral
   - Rampancy of informal markets
   - Weak asset registration framework (particularly vehicle)

6. Recommendations (and Challenges)

3. Adopt cash-flow-based credit assessment.
   - Lack of standard/reliable financial reporting
   - Absence of sound business and financial plan
   - Limited skilled workforce with technically-flawed credit assessment culture at MFIs

4. Develop more lenient policy and procedures in requesting for additional funding.
   - Increased administrative work
   - Prone to over-indebtedness
   - Attempt to conceal potential delinquency

6. Recommendations (and Challenges)

5. Revisit loan restructuring policy and procedures.
   - Unclear regulatory framework regarding the possibility to perform loan restructuring at MFIs.
   - Procedures in handling loan restructuring, particularly loan provisioning and re-classification.
   - Should be allowed for other business and/or financial hardship too.

7. Conclusion

- Key risks of mismatches between MFIs' product designs and customers' financial requirements: *"findings and discussions"*.

- Mitigating actions of the mismatches & risks: *"the five recommendations"*

- Areas for future studies/researches:
  - Demand-side of loan product
  - Small and medium microfinance

Thank You For
Your Attention