Social Finance Brief

April 2021

Designing emergency loans
The experience of Dvara KGFS

Key points

- Since its inception in 2008, Dvara KGFS has strived to build a unique model to meet the financial needs of rural customers to promote wealth creation.
- Over the past few years, Dvara KGFS has worked on offering a redesigned emergency loan product.

Introduction

Dvara KGFS is a non-banking financial company (NBFC) based in India. Since its inception in 2008, Dvara KGFS has strived to build a unique model to meet the financial needs of rural customers to promote wealth creation. It started with the group-based lending approach known as joint liability group (JLG) loans. JLG is a lending model that enables a group of individuals (usually five) to take loans for income-generating activities or other household requirements by forming a group, wherein the members guarantee each other's loans. Group-based loans for income-generating businesses is the core offering of most microfinance institutions (MFIs) across the world.

A JLG loan may not be sufficient to help a client cope with the financial pressure posed by an emergency, such as an illnesses or loss due to fire. In such circumstances, people typically turn to friends and family, or moneylenders who may charge high interest rates, posing additional pressure on the household's financial wellbeing.

An emergency loan is an alternate mechanism for MFIs to help their borrowers during times of need. Principal arguments for MFIs to offer an emergency loan are:

1. Income-generating loans do not eliminate vulnerability to economic or personal shocks. Most of the borrowers are still susceptible to such events.
2. Providing assistance at the time of a crisis can build client loyalty as the MFI can demonstrate that it is vested in the client's well-being.
3. Emergency loans can help reduce reliance on more expensive credit options available through informal moneylenders, thereby reducing the risk of falling into a debt-trap.
4. Consumption loans, including emergency loans, are not burdensome as long as the household can repay them. MFIs can ensure that the overall loan amount is not exceeding the borrower's repayment ability, to ascertain that the borrower is not over-indebted.

MFIs recognize the positive aspects of offering an emergency loan, particularly to stand out in the market, and attract and retain customers. Over the years, many MFIs have experimented with providing emergency loans to their borrowers; however, they have often faced challenges as many features of emergency loans are structurally different from group loans presenting some operational challenges for the MFI. The usual difficulties with an emergency loan product are:

1. *Quick turn-around-time (TAT)*: An emergency loan, as the name suggests, cannot be planned for in advance. In addition, it is usually meant for a small but immediate expenditure. Hence, TAT is of paramount importance for this product, and ideally, it should be less than 24 hours. However, MFIs usually lack the expertise to do

so, and since the emergency loan is a low-value product (due to the smaller loan size and interest earned), there is less incentive for MFIs to acquire this expertise or invest in resources to operationalise it.

2. *Individual loan*: Unlike JLG loans, emergency loans are typically for idiosyncratic events. Hence, they cannot be offered to a group and cannot be guaranteed by the group. MFIs may also lack expertise in assessing and servicing individual loans.
3. *Cost-benefit analysis*: Emergency loans are of small value, and the cost of delivery is often high, owing to expedited processes that are needed. Hence, in the short run (until efficiencies are built through systems or technology), the cost of servicing an emergency loan may outweigh the financial return from it.
4. *Misuse and mis-selling*: There is a risk that the borrower or the MFI staff can misuse the emergency loan, by directing the funds received towards group loan repayment in case the borrower is short on funds. This practice can keep up the portfolio quality in the short run but will have a detrimental impact in the medium to long term.

The case of Dvara KGFS

Dvara KGFS piloted its first emergency loan product in 2012, with some success. However, the challenges it faced resulted in the withdrawal of the product offering. In late 2019, Dvara KGFS introduced a redesigned emergency loan offering. The experience of both pilots is outlined below to shed light on challenges that other organizations may experience, and solutions that they can use to overcome those challenges.

The first emergency loan pilot

The first pilot of the emergency loan was done at the Ganjam district of the state of Odisha in eastern India. The purpose of this exercise was two-fold:

1. to add another product in Dvara KGFS' bouquet of offerings to establish itself as a one-stop solution for the financial needs of the rural customer,
2. to build a deeper relationship between Dvara KGFS and its customers.

▶ Key attributes of the emergency loan product

#	Criteria	Condition
1	Potential borrower	Existing enrolled customers
2	Loan purpose	• Death in family • Medical expenses of family members • Medical expenses for cattle of the borrower • Emergency travel requirements
3	Loan behaviour with Dvara KGFS	No default in existing loans with Dvara KGFS
4	Quantum of top-up loan	Up to 2,000 Indian rupees (US$27)
5	Rate of interest	24% per annum
6	Repayment frequency	Monthly
7	Collection point	At the same centre, date, and time as that of the existing loan
8	Approving authority	Branch Officer (same as JLG loan)

The following design features were incorporated into the product:

1. *Customer outreach*: Borrowers who had an established relationship with Dvara KGFS (i.e. more than 12 weeks) were eligible for the loan. They also needed to maintain a positive balance in a savings account and not have overdue credit at the time of application.
2. *Delivery channel*: An existing customer of high repute called “disbursement agent” handled the after-hour disbursements. This agent kept a lockbox with a three-digit code operated through SMS inquiry. The aim was to keep the TAT within 24 hours.

The design underwent several iterations during the pilot as the customer learnings and behavioural insights were generated. These lessons were fed back into the product design, such as:

1. *Loan term*: the original two-week term was extended to one month allowing greater flexibility to the borrower and enhancing the profitability proposition.
2. *Principal amount*: the maximum loan amount was increased from 500 Indian rupees (US$7) to 2,000 rupees (US$27) as INR 500 (US$7) was viewed as too low to be useful. INR 2,000 (US$27) was the loan amount permitted in line with commercial considerations to cover the cost of disbursal. However, this presented a problem, since borrowers who needed smaller amounts, ended up borrowing more than they needed, or they turned to moneylenders instead.
3. *Interest rate*: was kept at 24% per annum as opposed to the JLG loan interest of 21% per annum. A higher interest rate for the emergency was intentional, as

Dvara KGFS did not want customers to apply for the emergency loan instead of the JLG loan.

4. *Personal visits*: Dvara KGFS staff visited customers two days before the loan was due. Later, it realized that a two-day notice period was too late as it was not enough time for customers to secure the money. In the future, it considered making the visits earlier and not necessarily in person, but via a phone call.

The borrowers under the pilot district were asked about their coping strategies concerning financial emergencies in case borrowing was not an option. Cutting down on food expenses and putting off the purchase of necessities emerged as the predominant ways. The post-pilot survey also indicated that customers continued to rely on informal lenders for smaller sums and pawnbrokers for amounts that are more substantial.

Photo: Marcel Crozet / ILO

Scaling up the pilot

After the pilot, Dvara KGFS rolled out the emergency loan product to other areas of operation, including the Thanjavur district in the state of Tamil Nadu in the south of India, which constituted a significant size of the organization's overall loan portfolio at that time.

However, after the initial success of the pilot, the journey of emergency loan products at Dvara KGFS became more chequered. Issues became known through various sources, including customer complaints and word-of-mouth. Internal audit reports also highlighted problems. There was a strong correlation between the emergency loan disbursement and JLG loan delinquency.

Unsolicited disbursement was a key issue. In some areas, the emergency loan was being used to keep the loan books clean, i.e. if a JLG borrower defaulted on their loan payment, loan officers issued an emergency loan, without reassessing their ability to repay, to ensure that the JLG loan instalments were paid on time. This practice only made an already bad situation worse, and soon ballooned into larger loan defaults.

Another challenge was the misuse of the product by the borrowers. There were many instances of borrowers taking an emergency loan for non-emergency consumption expenses. Since emergency loans were disbursed with an extremely fast TAT, as quickly as 30 minutes in some cases, it was not always possible to ascertain the actual usage beforehand. It led to misuse of the loan amount, which adversely affected borrower's repayment ability.

Such malpractices, although localized to only a few clusters, resulted in bad publicity to the institution's brand value, adverse impact on portfolio quality and customer attrition. Hence, Dvara KGFS decided to discontinue the product and focus on improving mechanisms of internal control to ensure better customer experience on other loan products.

The revised offering

In 2019, Dvara KGFS relaunched its emergency loan product. The reason was the same as earlier—to strengthen the Dvara KGFS and the customer relationship; and stand by them in the hour of need, thus becoming a full-stop solution for all financial obligations. Core features of the product remain the same with a few market evolutions over time.

Before reintroducing the emergency loan product, Dvara KGFS focussed on two attributes to improve internal controls and ensure the product is not misused by its borrowers or by staff:

1. *Establishing post-disbursement utility check*: Dvara KGFS ensures submission of the physical evidence of loan utilization into the system later. In addition, if the borrower is unable to provide the proof, they are disqualified from utilizing this facility in the future. Dvara KGFS ensures that all the borrowers know this beforehand and hence avail of this product only if needed.
2. *Improved internal audit tool*: Dvara KGFS has developed a sophisticated internal audit mechanism that has vastly improved over time. The audit mechanism identifies for doubtful emergency loan disbursements for further

inspection. It uses many indicators for it, which are not known by borrowers or Dvara KGFS staff. Examples of indicators include disbursements close to the date of JLG loan repayment, or disbursements coinciding with festivities. Monthly reports identify these red flags, which are then reviewed by the credit team as well as by the sales managers at regional levels.

▶ Dvara KGFS's relaunched emergency loan product

#	Criteria	Condition
1	Potential borrower	Existing enrolled customers
2	Loan purpose	• Death in family • Medical expenses of family members • Medical expenses for cattle of the borrowers • Emergency travel requirements
3	Loan behaviour with Dvara KGFS	No default in existing loans with Dvara KGFS
4	Credit bureau (CB) report	All conditions of JLG loan apply for emergency loan
5	Quantum of top up loan	• Minimum – 1,000 rupees (US$14) • Maximum – 5,000 rupees (US$69) • In multiples of 1,000 rupees (US$14) only
6	Rate of interest	26% p.a. (reducing balance rate) (same as JLG loan)
7	Processing fees	1% of the Loan Amount
8	Loan term	Six months
9	Repayment frequency	Monthly
10	Debt service coverage ratio	Monthly income/Monthly debt obligation >=1.5
11	Collection point	At the same centre, date and time as that of the existing loan
12	Checks	• Know your customer (KYC) correctness • CB report checking • Loan documentation checking

The results so far

Dvara KGFS is monitoring the performance of the emergency loan closely to ensure that it has a positive effect on delinquencies. In its staff training, the emphasis is on identifying the purpose for which the emergency loan is being sought; specifically that it is suitable for low-ticket individual financial emergencies.

The microfinance industry in India has also matured. At a country level, there are large pockets where it has reached saturation level, meaning that the microfinance customers are more experienced. Improved KYC mechanisms through the Unique Identification Authority of India issued Aadhaar card has ensured that credit information companies have more reliable customer data. These developments have led to fewer misuses of the loan proceeds, as it is increasingly difficult for borrowers to get away with purposeful default, and they know it.

An emergency loan should have a band-aid effect on the financial injury of the borrower. If misunderstood as the treatment, the injury will eventually flare-up. In the given context, flaring up would mean credit delinquency/default. Both the borrower, as well as the lender, must realize that this is only a stopgap measure to smoothen cash flows in the short-term, and not a long-term solution. Therefore, in addition to having post-disbursement checks, Dvara KGFS is trying to ensure that its staff understands these critical aspects of the emergency loan and adheres to them.

Results from the second pilot will be available in the coming months, but Dvara KGFS expects that the enhanced internal controls have addressed some of the challenges that were faced during the first pilot.

The Impact Insurance Facility contributes to the agenda of Social Finance by collaborating with the insurance industry, governments and partners to realize the potential of insurance for social and economic development.

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