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SmartLessons

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Fulfilling the Housing Dreams of Microfinance Clients

Rahees Mohammed and his wife lived in a rented house in a slum and had one wish—to build a house that would be a permanent home for the whole family. Aadhar Housing Finance Private Ltd. could help Rahees realize his dream by offering a housing finance product that corresponded to his needs, preferences, and capacities. This SmartLesson, building on Aadhar's experience and that of our other housing finance clients in South Asia, provides a brief overview of the dos and don'ts for the implementation of housing finance products.

Background

Aadhar offers housing finance loans to households earning US\$1,200 to \$4,800 per year and with no proof of income, such as self-employed business owners like Rahees. It offers smaller loans for repairs or incremental construction as well as mortgage loans. Aadhar entered the housing finance market in 2010 with IFC's support. In addition to the financial support, IFC provided advisory services covering market entry strategy, product design, sales and market approach as well as advice on the risk management framework. As of June 30, 2014, Aadhar's housing finance portfolio amounts to US\$ 102.5 million.

Why enter the housing microfinance business?

Housing microfinance (HMF) is a subset of microfinance and fits well into the microfinance mission. It is designed to meet the housing needs and preferences of low-income groups, especially those without access to the banking sector or formal mortgage loans. HMF is intended for low-income groups who wish to expand or improve their dwellings or to build a home in incremental steps, relying on sequential small loans. Loan sizes vary from US\$ 800 to US\$ 3,000, and the tenor



Rahees Mohammed and his family enjoy their new home. (Photo courtesy of Aadhar)

ranges from 24 months to 60 months. Interest rates in India are from 22 percent to 24 percent. Microfinance institutions require collateral for loans exceeding US\$ 1,500. 80% of Aadhar's customers have a monthly salary below US\$ 550.

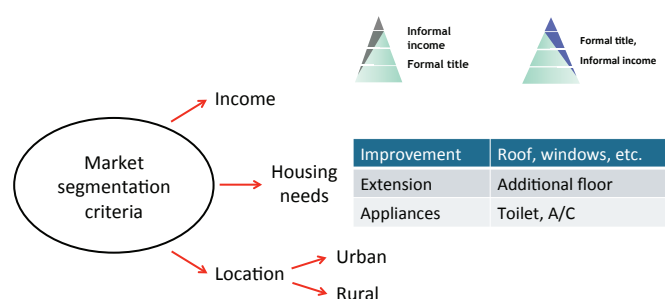
For many microfinance clients, the home is also the place of production for their

micro or small business. Clients who can improve their housing conditions experience an increased quality of life and well-being and, as a result, become more productive, creative, and satisfied. Those clients who take out HMF loans are considered lower credit risks and more satisfied customers.

HMF also allows microfinance institutions to retain existing clients or attract new clients. According to anecdotal experience, about 10 percent to 20 percent of microfinance loans are used for housing. By offering HMF products, a microfinance institution improves its risk-management framework (especially through diversification and better identification of risks).

Because of rising demand for housing finance in South Asia, entering this market offers an unrivalled opportunity for microfinance institutions. They are likely to benefit from enhanced profitability and sustainability of their overall operations. Key to achieving sustainable and profitable operations is having the right product and right strategy. This includes a good understanding of the difference between needs, preferences, and capacities as well as clear market segmentation (see Figure 1).

Figure 1: Illustration of Market Segmentation



Source: Friedemann Roy.

Lessons Learned: DOs and DON'Ts for Entering the Housing Microfinance Market

The following dos and don'ts for the implementation of housing-finance products offer guidance for microfinance institutions that plan to develop a strategy to enter the housing-finance market.

1) Do understand the demand patterns of your customers.

Depending on the size of the housing project, the demand for financing differs. The three elements listed below influence customers' needs (improvement or extension), preferences (type of material used), and capacities (whether the work will be completed by the customer or by hired professionals):

1. **Income and title.** Microfinance clients may have a formal salary and an informal title or vice versa. To

assess creditworthiness, microfinance institutions can rely on the same methods as for microfinance loans.

2. **Housing needs.** Clients may use the loan proceeds for home improvement, extension, or appliances (such as toilets).
3. **Location.** Depending on where the microfinance institution operates, loan amounts may vary. They tend to be higher in urban than in rural areas.

2) Do a detailed market assessment.

The goal of the market assessment is to identify the potential and effective demand: 1) to identify the potential target clientele, 2) to determine the potential demand and the size of the market (effective demand), and 3) to ascertain the affordability levels of the target segment. Other important aspects of the market research are a thorough assessment of the enabling environment (such as economic development, legal and institutional framework, housing sector) as well as a competitive analysis. The findings of the market research will provide the basis for the final design of the housing-finance products.

3) Do assess institutional readiness and capabilities.

The goal of this evaluation is to identify the necessary organizational adjustments needed within the institution and the costs of implementation. It should take into consideration the following elements:

- **Interest and willingness to expand into housing products.** To ensure sustained institutional interest, it is essential to get support from all key management, board of directors, and investors.
- **Financial and operational performance.** The institution should already have some experience with lending operations. In India, the asset base of a microfinance institution should be at least \$20 million. Prior experience with individual lending products is not a requirement; it can be obtained through the launch of HMF products. In other regions, microfinance institutions have often used HMF products to offer loans to individuals. The management information system, however, should have the capacities necessary to process individual loans of longer tenor and larger ticket sizes.
- **Funding and other resources needed for pilot implementation and scale-up.** As HMF loans typically have longer tenors than microfinance loans, microfinance institutions should also have access to longer-term funding in local currency to keep asset-liability mismatches at a minimum. Also, sufficient staff resources should be available or be recruited to ensure smooth implementation. These people should have appropriate knowledge of banking and housing finance.

4) Do build capacity and appropriate incentive systems for staff involved in housing.

Capacity building of existing and new staff members is critical to a successful rollout of HMF product offerings. Also, management should appoint a dedicated and fully empowered project manager (“product champion”) to be in charge of the implementation process. In South Asia, microfinance institutions that have invested in appropriate capacity-building measures (particularly in individual credit assessment and basic construction and technical knowhow)—from the beginning of the implementation process—have demonstrated superior performance.

Some institutions expand the duties of staff members whose current job is handling the group-lending portfolio, having them offer housing loans as well. In this case, management needs to align the incentives and targets of these twin goals appropriately.

5) Do consider introducing housing support services (HSS).

HSS or construction technical assistance (CTA) services are products and services that enable households to improve their houses on their own. They can range from providing process support for registering land titles, or advice on construction and materials, to community development. There are three broad categories of these products and services:

1. **Pure technical information.** The lender provides brochures, videos, contact lists of masons, and so on, to customers. These services can be provided by lender staff. Professional support is required to design the brochures or any other material.
2. **Professional services.** The lender provides support for the design and planning process, trainings, permit processing, and so on, possibly including visits by technical staff to the borrower’s home. The lender may cover these services through a cooperation agreement with an architect or other service providers.
3. **CTA/engineering advisory.** The lender provides onsite support at the borrower’s housing unit, ranging from basic (repairs) to structural work (such as masonry or plumbing). Structural work is the most intensive form of housing support services and typically requires the employment of an engineer.

In determining how to deliver housing support services, it is important to create an effective link between the provision of these services and the HMF offering. Market research should clarify whether customers would consider the availability of CTA an added benefit, which

types of services they prefer, and how much they would be willing to pay for the services.

6) Don’t underestimate the aberrations of an uncertain regulatory environment.

In countries such as India, where the regulatory framework for microfinance institutions is still unclear, implementation success could be negatively affected by ambiguous regulations and directives. Current regulations of India’s central bank do not allow microfinance institutions to lend more than 30 percent of their loan book for non-income-generating loans, which includes housing finance. At present, an amendment to this rule, which envisages a relaxation of this limit, is pending approval by Parliament. It is therefore prudent to conduct a thorough review of all the laws and regulations dealing with HMF operations. This work should be covered within the market assessment.

7) Don’t fail to upgrade internal systems and processes.

Individual lending—and in particular housing finance—requires a clear diagnostic and an overhaul of all key internal systems and business processes. The move from joint-liability-based lending to detailed cash-flow-based assessment necessitates revisiting and modifying (or establishing) the following internal business processes:

- **Technical appraisal.** Incorporate technical-appraisal capabilities within the institution to improve credit appraisal, disbursements, and loan-use checks (preferably with the field-level loan officers).
- **Documentation requirements and pre-sanction process.** Understand the particulars of legal documentation for a specific geography and incorporate this learning into loan sanction and documentation requirements.
- **Loan-use checks and repayment processes.** Be sure loan-use checks (such as photographs to accompany staged disbursements for larger ticket sizes) are in place; also gear your systems for monthly repayments, as opposed to the weekly/fortnightly collections for a typical microenterprise loan.
- **Delinquency management process.** Upgrade the delinquency management process to account for longer-term housing-finance loans as well as prepayment possibilities.

8) Don’t fail to set up robust responsible lending, customer protection, credit bureau reporting, and disclosure practices early on.

From the beginning of the implementation process, build a responsible housing-finance framework, because it will result in enhanced customer awareness and consequently better risk management. To ensure

robust credit appraisal and an appropriate product design, it is advisable to embed customer-centric practices across the entire business operations. Such practices include the following:

- Clear and full disclosure of housing loan terms (such as interest rate and tenor);
- Efficient grievance-handling mechanism for individual lending;
- Credit bureau reporting, beyond basic compliance requirements, to aid credit assessments of clients;
- Staff trainings that incorporate ethical behavior for staff and sales agents;
- Customer-friendly collection practices, which could involve exploring electronic transfers;
- Raising awareness on documentation requirements, technical assistance, and so on.

9) Do consider scaling up the HMF offering after the pilot and some operational experience.

Before a nationwide or statewide rollout, the HMF product offering should be tested through a pilot, and the results should be reviewed and adjustments made. According to experience in South Asia, the following areas may require modifications:

- Loan size sought by customers;
- Down-payment requirements from customers to ensure their willingness to repay the loan;
- Disbursement in tranches or in one lot.

Once the pilot is completed and after a year of operations, management may consider scaling up HMF operations. Within the Indian context, there are the following models:

- Continue with HMF lending within the existing set-up through organic growth;
- Act as a sourcing and collection agent for larger banks or housing finance companies (HFCs) that plan to go down-market;
- Establish a stand-alone HFC, bank, or nonbank financial institution, as specific country regulations allow.



A client of Ujjivan Microfinance Pvt. Ltd., in New Delhi.
(Photo by Shilpa Rao and Sachin Bansal)

Conclusion

Microfinance institutions, such as Aadhar, that have pursued a rigorous albeit flexible approach to the rollout of their HMF product offering have been quite successful and are today's market leaders. Thorough market research and internal capability assessment are critical success factors. The appointment of a staff member as HMF product champion ensures a smooth implementation process—so long as he or she enjoys the full support of management.

Another crucial element is a critical review of the pilot to allow for further changes, to hone the product offering and the sales and marketing approach. However, to retain a competitive edge in the microfinance institution's housing-finance market, management should constantly review the performance of the HMF loan portfolio and be ready to make further adjustments.



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