

## **Flexible Repayment Schedules for Dairy Clients in KAS Foundation, Orissa**

### **Project background and significance**

Most MFIs offer loan products with fixed weekly or monthly repayment schedules. Yet fixed repayments may not be best for most clients, particularly if their income is subject to variations due to seasonal activities, business cycle, health and other risks.

Are MFIs too rigid with repayment schedules on loans? Loan-defaults or difficulties in repaying have been noticed in borrowers engaged in seasonal enterprises. Many are unable or find it difficult to pay back during the lean period, and often dip into their savings and consumption expenditure. Many also find themselves indebted to informal creditors. Can MFIs then allow more flexibility?

KAS Foundation (KAS), for example, has a monthly repayment system for its SHG clients. Most rural clients of KAS work in the dairy industry and face lean seasons in milk production. For these clients, fixed monthly repayment schedules may not be optimal as they do not correspond to the households' flows of income.

The capital required for these short-term activities is very low (from \$ 4 – \$40) and the returns can be as high as 100% within a three-month time frame. Would it make sense, therefore, if KAS Foundation exempted clients from monthly repayment obligations during the lean season so that clients would be free to undertake some of these income generating activities? KAS Foundation's recovery performance would also not be hindered then.

### **Programme description**

KAS Foundation is an MFI operating in the states of Orissa and Chattishgarh. It offers loans through Self Help Groups and Joint Liability Groups to more than 400,000 clients (about 14,000 SHG and 34,000 JLG). The routine product is a Rs. 4,000 (\$ 67) loan, with 24 months loan tenure @ 10.75% flat per annum interest rate with fixed, monthly repayment schedule of principal plus interest per month.

To help design new dairy loan products, CMF conducted one month of focus-group discussion market research among KAS Foundation's dairy clients. Based on the findings, two products were recommended. Both products are INR 6,000 (\$133) loans of 24 months loan tenure at 10.75% annual flat interest rate.

#### ***First product: Dairy Research Advance Payment (DRAP)***

Clients need to repay two principal installments and one interest installment in the first six months. After six months, clients are entitled to skip any six principal installments in the remaining loan tenure since they have already prepaid six additional principal installments.

#### ***Second product: Dairy Research Coupon Based (DRCB)***

At the time of disbursement, clients are provided with a booklet containing 24 monthly principal installment coupons and 24 monthly interest installment coupons. In the first three months, monthly principal and interest payments are mandatory for all clients. Thereafter, clients make mandatory monthly interest payments, but are allowed lag behind two principal installment obligations.

DRAP works like a debit card—the flexibility option depends on the performance of the clients in the previous six months. DRCB, on the other hand, works like a credit card—the flexibility option can be availed of first, and then the skipped principal installments can be made up.

### ***Standard product with higher principal***

In addition, a credit product similar to the KAS Foundation routine product, but with a higher a principal amount of Rs. 6,000 was proposed, as this amount is more appropriate for the purchase of a cow. The impact of this product alone will also be analyzed in order to isolate the effect of higher principal in the two flexible products.

### **Research design and analysis**

The objective of this project is to analyze the performance of these three innovative products against the KAS Foundation's routine product. The study will focus on the impact on clients' households' welfare, their ability to smooth consumption and to invest in other productive activities during the lean period.

Since flexible schedules, however, can strain the organizational capabilities of the MFI and lead to increased transactions costs or higher levels of operational risk, CMF will also analyze the impact of the two proposed loan products based on KAS Foundation's recovery performance and study the consequences of the change in repayment schedule from the operational, financial and risk perspectives.

In order to avoid issues of non-comparability between the different groups availing different products, the assignment of Self Help Groups to one product or the other was done randomly. 50 groups receive the Dairy Research Advance Payment, 50 groups the Dairy Research Coupon Based, 50 groups the standard product with higher principal, and 50 groups, which serve as control groups, receive the standard KAS loan product.

A baseline household survey was conducted to measure the existing households' socio-economic conditions, and is now followed by short quarterly surveys designed to track income flows and identify any patterns or logic in skipped principal payments. Larger surveys will be conducted after two years and at the end of the loan tenure.

### **Contributions**

The Grameen model is widely accepted and trusted among Indian MFIs. However, do we really know what would happen if we made fixed repayment schedules flexible? More flexible products may attract more clients, lead to higher impact while keeping default rates unchanged. It is important to carefully weight costs and benefits of different product

designs. The mismatch between fixed debt payments and lumpy income flows can create distortions. Though fixed debt contracts have benefits – avoiding operational headaches, cash management problems, risk of loan officer fraud and weakened repayment discipline of borrowers – the benefits of flexibility could be huge. First, rigid contracts may greatly constrain loan size since debt capacity is based on income in the bad weeks or months. Second, the rigidity of contracts may be keeping some borrowers from borrowing. Finally, flexible contracts may greatly increase the impact of the loan since clients with rigid contracts may take actions which reduce the return on their investments. Flexibility could be practically implemented in the current micro-finance structure in different ways. But will these products work? Will they erode repayment discipline and increase default? Or will they allow for much larger loan sizes and greater client income growth? There is only way to know if microfinance can be more flexible: to test flexibility through careful research. This project is one such attempt.

**Timeline**

The Project started in January 2006.

The baseline was completed and quarterly surveys are now going on.

The project is expected to be complete by August 2008.