

EMERGENCY HAND LOAN

A Product Design Case Study



Product Design Case Studies

Overview

The poor and other underserved populations in developing countries have unique financial services needs. However, there is often a mismatch between what financial institutions offer and what underserved populations need or want. This ‘product gap’ may reflect a lack of interest by financial institutions in designing more target products, or a lack of willingness or capacity on the part of financial institutions to design, market and implement tailor-made financial products.

A better understanding of successful products and the processes behind their design, development and implementation may help increase Access to Finance for underserved populations. In line with IFC’s learning agenda on responsible financial inclusion, the *Product Design Case Studies* were established to bridge the gap between product design/innovation and financial inclusion; increase knowledge related to product design and development processes; and focus attention on the end beneficiaries of financial products.

The objectives of the *Product Design Case Studies* are to 1) develop expertise related to product design and innovation processes through a better understanding of best practices in the field, in-depth research and application of behavioral economics concepts; 2) increase awareness of product design/innovation and the links between product development and financial inclusion; and 3) generate publicity and knowledge sharing around product design and innovation.

IFC has partnered with ideas42 to research and develop the *Product Design Case Studies* with a particular focus on behavioral economics. The case studies present useful products and product innovations that are scalable across a broad range of markets and offer broadly valuable insights into features of successful products, customer behavior and the product development process itself. The case studies also highlight the benefits for financial institutions of implementing or designing new products, as well as the corresponding effect on responsible financial inclusion of underserved populations.

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Emergency Hand Loan

Overview of the Case Study

The objective of this case study is to describe the design, implementation and results of piloting an emergency hand loan product in India, highlighting lessons learned about the product innovation and implementation process. While the hand loan product was broadly successful in achieving its original intent, the pilot encountered considerable institutional and execution challenges that are instructive for future product innovation efforts.

The first two sections describe the problem and the innovative product designed to address it. The next section describes the final design and implementation of the product in detail. The fourth section covers post-pilot data collection and results. The final sections discuss lessons learned and planned future enhancements.

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The Problem: Shocks

A growing body of research on the economic lives of the poor in developing countries emphasizes that the already difficult task of making do on a few dollars a day is made harder still by the unpredictability and variability of poor peoples' incomes. A key insight that emerges from this research is that basic, day-to-day money management is one of the central financial concerns of poor households.

But the poor often have to manage their incomes without reliable, affordable financial instruments designed to meet their needs. For example, most poor people in developing countries lack a safe place to store what they may be able to save during periods of higher-than-average income. As a result, when income is low or when emergencies that call for large expenses occur, they have no financial cushion upon which to draw.

Often, credit options are also limited. Few banks provide credit products designed to meet the occasional liquidity needs of the poor. Microfinance institutions (MFIs) tend to offer credit products that are ill-suited to meet emergency-financing needs: the loan amounts are often too large and carry interest rates too high to be viable sources of emergency funding. Such loans are also usually only available during business hours; emergencies, unfortunately, can happen at awkward times.

Most people in need of quick loans to cope with an unexpected expenditure or cash shortage therefore rely on informal loans from local moneylenders, family and friends, employers, and so on. These informal loans have some virtues that few formal instruments, if any, can match: they are available at short notice and are easily accessible. They are also often available in the small sums needed to tide over a short-term cash crunch, rather than in large denominations as with MFI loans. Because informal lenders are often located in the same community and may have previously lent to an individual, they have an existing relationship which both makes them more confident of being repaid and makes people likely to turn to them for emergency funds. However, despite these advantages and the clear need satisfied by informal loans, the lending and loan-collection practices of informal moneylenders have many drawbacks for borrowers.

These issues - the need for such emergency loans, the lack of formal alternatives and the drawbacks of existing informal sources - all emerged in rural Orissa in eastern India, where the field research underlying this case study was carried out. Many people reported borrowing from pawnbrokers for emergency spending. Pawnbroker loans require collateral, typically jewelry. However, the loan is usually only a fraction of the actual value of the collateral. A failure to repay on time results in jewelry being forfeited and sold for its market value, resulting in a large loss for the borrower. (For instance, the pawnbroker may only accept a necklace worth 1,000 rupees for a loan of 600 rupees and if they are not repaid proceed to sell the necklace, making a profit of 400 rupees.) In other words, in case of default, such loans can end up being extremely expensive.

In addition, those interviewed also reported that pawnbrokers routinely responded to delayed payments or lack of repayment by resorting to publicly shaming the borrower. For instance, the pawnbroker may follow the borrower through the village while shouting reminders for them to pay for all to hear. This type of public shaming can be very effective in getting people to repay but also tarnishes the borrower's reputation in the village. Borrowers also report similar damage to their reputation and social standing arising from delinquent payments on loans from their social circle.

Informal lenders have a clear first-mover advantage in terms of being established, known sources of such finance. People have used them, know what to expect and, most importantly, know from past experience that loans will be available as needed. Nevertheless, the drawbacks of informal moneylenders' practices, as well as the shortcomings of existing formal products, represent an opportunity (albeit a challenging one) for formal institutions.

Rather than resorting to shaming people, formal products that provide more civil means of reminding the borrower to repay (such as private reminders via text messaging) could attract users. More generally, the recognition of people's need for credit as a smoothing device or a way

to tide them over during an emergency leads to a very different kind of product than thinking of loans as essentially small-business loans. It leads to different design principles with regards to size, interest rates, repayment schedules, etc. But the advantage that informal lenders already enjoy means that even if a formal product offers better terms and is as convenient (or more convenient) than an informal product, it has additional barriers to overcome before it can grab a significant piece of the market.

The Innovation: Emergency Hand Loan

The Emergency Hand Loan was developed by the Center for Innovative Financial Design (CIFD) at the Institute for Financial Management and Research (IFMR) and offered by Dhanei KGFS, a financial service provider operating in Ganjam District in Orissa, India. The product provides an easily accessible loan for customers to meet basic needs that they cannot afford in the immediate term. These could be medical or education expenses, although the loan is flexible in its use.

The design of the Hand Loan attempts to replicate the convenience offered by existing informal sources of emergency finance. Once an eligible customer indicates why he needs such a loan, it is distributed within minutes. Like informal loans from moneylenders or local pawnbrokers, it is available even outside business hours. Risk and appropriate usage are managed by setting the amount and term such that the loan is only useful to cover short-term cash shortages of the type caused by emergencies.

The Hand Loan was made available to 450 eligible customers at Dhanei KGFS. Of these, 225 took out at least one loan, with some taking out several between January and July 2010. A preliminary evaluation suggests that the Hand Loan has displaced some sorts of informal loans, particularly those obtained from pawnbrokers, who often charge high interest rates and require collateral that is sold if the loan is not repaid on time (see Background above). Less expectedly, however, we found that some customers quickly repaid their Hand Loan using salary advances from their employers that generally charge no interest and can be repaid in small installments.

The Hand Loan is in its first iteration (i.e. pilot phase) and has proven to be successful in its main objective of providing convenient, formal access to finances for low-income families. However, the design (loan amount and term) was altered by the bank during the pilot approval process, and was changed further during implementation (fixed rather than maximum amount, failure to communicate importance of timely repayment). It is now apparent that some of these changes were motivated by a need to ensure short-term profitability. Future iterations will need to rectify these issues while also alleviating real business concerns. Pilot results also point to other enhancements based on a better understanding of customers' usage of the product, for example SMS payment reminders.

Design and Implementation

Product design and development

The Hand Loan product was designed by the Center for Innovative Financial Design (CIFD) at the Institute for Financial Management and Research (IFMR) and ideas42. In prior research and fieldwork, CIFD noted a lack of reasonable loan products for low-income households in the region and peoples' consequent reliance on convenient but expensive loan products from informal lenders, whose methods of loan recovery were also fraught with social and reputational risks for borrowers. These insights were largely derived from qualitative research conducted with the target population as part of other research.

The Hand Loan product design was driven by two key objectives. The first was to provide families in Orissa with convenient and affordable financial access. The funds were meant to be reasonably priced so as to discourage the use of informal lenders charging high rates. The second key objective was to establish the foundation for a deeper relationship between the bank and customer, paving the way for future business. By providing the same emergency finance services as moneylenders, potential and current customers perceive the formal financial service provider as trustworthy and generally responsive to their needs. Thus borrowers who had been helped in times of distress would (it was hoped) be more receptive to other bank products at different times. At the same time, the loans would also serve as a means for the bank to screen potential borrowers and learn about their repayment behavior, allowing those with good repayment records to be identified as potential clients for larger, longer-tenure loans.

A loan with a short term and small amount was designed to naturally limit usage for emergencies that are characterized by short-term cash flow shortages. The behavioral insight underlying the design is related to the concept of mental accounting which suggests that people think about money in separate "mental accounts"¹. Emergency cash short-falls should be small amounts, last a short period of time, and be in an "emergency" mental account. A loan that relieves the emergency should match the small amount and short timeframe of the emergency. As a result, people should view such a loan as only useful to resolve emergencies. Framing the loan as an "emergency hand loan" further strengthens that categorization. For the purpose of setting the official terms of the loan, a list of acceptable emergencies was developed including (but not limited to) an accident, sickness or hospitalization; a death in the family; livestock sickness; natural disasters; payment of school fees or utility bills; weddings; and continuous rainfall for more than three days with consequent wage loss.

As part of its efforts to grow significantly in terms of both number of clients and products offered, Dhanei KHGS formed a partnership with CIFD to field test the Hand Loan in one of its service areas. Dhanei KGFS is a non-banking financial company (NBFC) launched in 2009 by the IFMR Trust Holding Company (ITHC) in order to provide innovative financial services to under-served rural areas. Dhanei KGFS operates in Ganjam District in the Indian state of Orissa and currently holds 18 branches serving around 20,000 clients. At the time of writing, its product portfolio consisted of 10 products, including various loan products, insurance schemes, and a remittance product.

¹ Thaler, R. H. (1985). "Mental Accounting and Consumer Choice." *Marketing Science* 4: 199-214.

Design during implementation

For purposes of implementation, the original product design underwent changes recommended by Dhanei KGFS, the MFI partner. The Hand Loan has now completed the first round of implementation, covering 225 customers during a period of seven months. During the survey and feedback phase that followed, customers and relationship officers were interviewed to understand which features of the current design need modification and what sorts of additional features it would be useful for the product to have in future iterations. (Future changes to the product, based on the final design, are explored in the Lessons Learned and Future Improvements section). Key design changes and their implications include the following:

- **Term of the loan.** The original two-week term of the loan was extended to one month to provide more flexibility for the customer but also to increase revenue from interest.
- **Principal Amount.** The maximum loan amount was increased from Rs. 500 (approximately US\$22) to Rs. 2000 (US\$45) since smaller amounts were viewed as too low to be useful. In the execution, Rs. 2000 was the only available loan amount, rather than the maximum. This was done to ensure that each loan would earn Rs. 40 (2 percent) per month in revenue to cover the costs of disbursement. A smaller loan amount was not seen as profitable by Dhanei KGFS. However, this presented a problem for customers who only needed to borrow a smaller amount, as they would be more likely to borrow and spend more than necessary or turn to informal moneylenders to take out smaller loans.
- **Interest rate.** The product was originally conceived as interest-free with the sole goal of deepening the relationship with the customer; however, the MFI felt that an interest rate of 2 percent was appropriate since the Rupee cost would be small for a one-month term. Again, this was in the interest of profitability--and obviously not as beneficial for the customer-- but the rate is still significantly lower than borrowers would pay through informal means.
- **Personal Visits.** Originally the MFI was going to conduct check-up visits on a small sample of borrowers after disbursement. Ultimately, the bank instead focused on visits as repayment reminders, usually two days before the loan was due. This reminder was later seen as too late and, in the future, will be made earlier and not necessarily in-person.

Profitability

The original design of the product explicitly assumed that the product would be a loss leader that would deepen clients' relationship with Dhanei KGFS. The interest rate was originally designed to be zero and the operating cost was to be minimal because no in-person verification or visits were required. The amount of loss per loan was not estimated, as the goal of the pilot was to test whether the relationship effects materialized before starting to optimize cost. Therefore, details on product profitability cannot be determined for the pilot phase. However, as described in the previous section, various changes to the product were made to increase revenue, though it was still not independently profitable. Qualitative client feedback does indicate that the relationship improvement benefits are likely to accrue in the form of greater retention and profits for Dhanei KGFS. Calculating the exact financial cost-benefit of the hand loan will require a randomized controlled trial.

The common thread across the design changes appears to be to bring the design closer to Dhanei KGFS's comfort zone – longer term, larger amount, interest earning, in-person verification, product-level (rather than portfolio-level) profitability. These also had implications for the borrowers and, depending on the change, increased or decreased customers' benefits. This product went through the MFI's full, formal new product approval process instead of being treated simply as a pilot. It is possible that the formal review drove more changes but there was also considerable push-back on the original design from the branch management and staff on the ground.

For this first iteration of the pilot, the design team felt it was important to incorporate input from the MFI as no evidence was yet available to contradict or confirm anyone's intuition about the product design. It is common for implementation details to be obscured during pilot testing; however, these details can be hugely influential. For instance, the timing of reminders can greatly affect repayment rates. Future iterations of the pilot can be informed by evidence and profit needs can be more explicitly addressed. Changes meant to increase short-term profitability do not always coincide with benefits to borrowers. This is especially true in the case of the Hand Loan which is meant to engender longer lasting relationships between the borrower and the MFI. Consistent and clear communication between the two parties is necessary for this type of relationship and takes sufficient time to build. Therefore, success with this product will be measured in the long-term both in terms of financial stability for the borrower and profitability for Dhanei KGFS.

Customer outreach

Customers who had an established relationship with the bank were deemed eligible to apply for a Hand Loan. An "established relationship" was defined as follows:

- Having been a customer with Dhanei KGFS for at least 12 weeks
- Carrying a positive balance in a savings account or MMMF (money market mutual fund) with Dhanei KGFS
- Not overdue on any other loans with Dhanei KGFS.

Around 450 people in the pilot service area met these criteria and were sent letters with plastic tokens ("Emergency Card") from wealth managers, who informed them about how to take up a Hand Loan and the resulting repayment obligations. The token approach was used so that eligibility would not have to be determined at the time of disbursement. After-hours disbursement would have been too difficult if eligibility was not previously established.

Final product features

Currently, the loans are of modest value (maximum Rs. 2000, US\$45 at current exchange rates) and have a maximum tenure of one month, reflecting their intended use to manage cash flows for a short period. In the letter of eligibility, borrowers are sent a plastic token that acts like a credit card with Dhanei KGFS. When they come to the bank they need to bring the token along with the pre-approval letter and proof of identification. To take out a loan they then have to sign a demand promissory note agreeing to the terms (2 percent interest payment--Rs. 40--for one month and penalties for each day of delinquency).

In an innovative channel design, after-hours disbursements are handled by an existing female bank customer of high repute acting as the MFI's agent. This decision was driven by the widespread perception amongst microfinance practitioners that women are more prudent and trustworthy than men in dealing with money. As an incentive, the agent receives Rs. 20 per loan disbursed. The agent has a lock-box containing Rs. 2000 with two 3-digit number locks on it. When the customer needs emergency cash, she calls a Dhanei KGFS call center and provides her customer number and describes the emergency. The call center then gives the customer the code to one of the locks and also sends it to the customer by SMS. The call center rep then calls the disbursement agent and gives her the code for the second lock. Using both codes, the lockbox is opened and the funds disbursed. A Dhanei KGFS wealth manager replenishes the funds in the lockbox the next day and resets the lock codes.

The Hand Loan contributes to responsible financial inclusion by providing a convenient and affordable product to people in the region. This is achieved by making funds easily accessible at all hours at an interest rate that is much lower than those charged by the prevailing informal moneylenders and MFIs. The Hand Loan is designed to be customer focused and available to help customers during difficult times while also providing a "gateway" to additional banking services for lower-income households. Future iterations of the product will solidify and enhance these attributes by providing more flexibility and better communication between the customer and the bank.

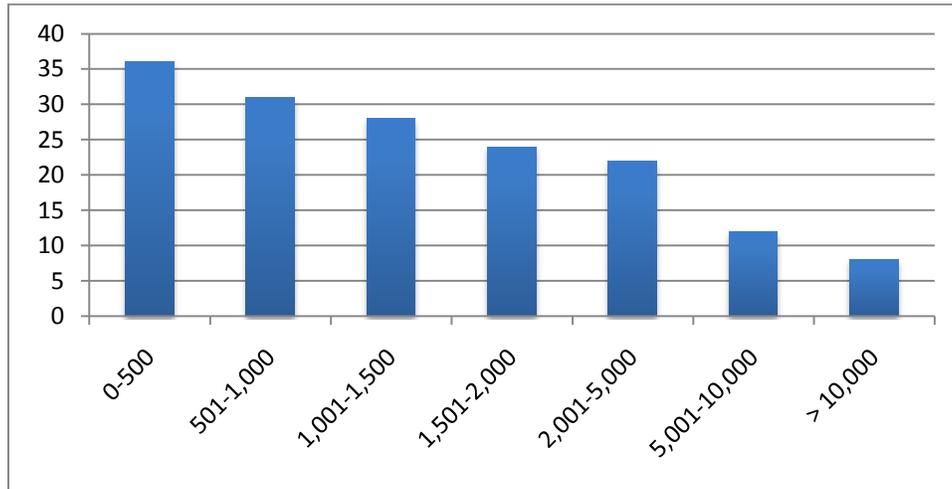
Client Feedback and Results

Data from the management information system (MIS) at Dhanei KGFS were analyzed to track the inception and progress of Hand Loan take-ups. In September 2010, CIFD conducted a product assessment of the Hand Loan to determine whether it met pre-defined success criteria including perception of the product, take-up, repayment, financial viability, and establishment of a customer relationship. For this purpose, 79 people who live in the service area of the branch where Dhanei KGFS piloted the Hand Loan were interviewed. The sample of people interviewed included both those eligible to take out Hand Loans (including some who had taken out loans) as well as others in the catchment area, including but not limited to existing customers of Dhanei KGFS. In addition, in-depth interviews were carried out in order to complement the broad picture gleaned from the main survey.

The following are the main findings from the data collection and client feedback gathering activities.

Cash shortages were frequent, especially small shortages.

Chart 1: Frequencies of People that faced at least one Cash Shortage in the various Ranges (rupees, n=77)



It is not surprising that smaller cash shortages are more frequent. This supports the need for greater flexibility in the loan amount (as originally designed) under the Hand Loan; making smaller amounts available would cover a higher share of emergencies experienced by the target group.

A majority of respondents expected future income to solve the cash shortage within 30 days.

When asked how long a period they expected to have to bridge before their own income materialised, 38 out of 74 surveyed mentioned a period of less than thirty days, suggesting that the current tenure of the Hand Loan matches the needs of the target population.

Preferences and capacities to deal with financial shocks vary by amount of short-fall.

Interviewees were asked if they would have to borrow money if they were facing immediate cash needs of Rs. 2,000, Rs. 1,000, and Rs. 500. Out of 76 valid answers, 64 indicated that a sudden but inevitable expense of Rs. 2,000 would force them to borrow. Forty-nine respondents said they would need to borrow money to cope with a shortage of Rs. 1,000, and 39 reckoned they would have to take up a loan if they had to spend Rs. 500 instantly.

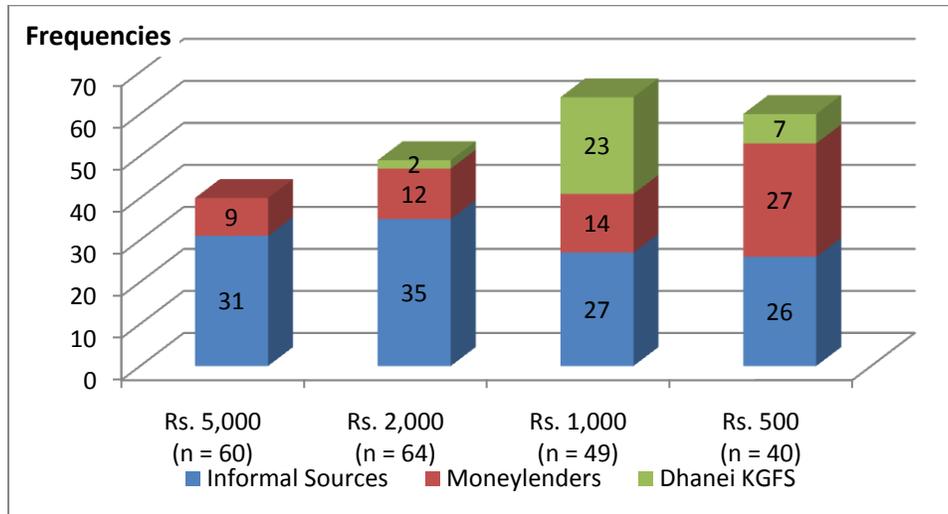
People were also asked about their coping strategies with respect to financial emergencies in case borrowing money is not an option. Trimming food expenses as well as putting off purchases of basic necessities such as clothes emerged as the predominant ways to cope with urgent financial needs absent the ability to take out a loan.

Interviewees were also asked whom they would ask first in order to gather the money needed in the different scenarios. The answers provided a sense of the degree to which Hand Loans from

Emergency Hand Loan

Dhanei KGFS are accepted tools for cash flow management. (Chart 2 depicts the result.) In the ranges below Rs. 2,000 people prefer to borrow from informal money sources such as friends, relatives or neighbors. Respondents point out that these individuals can provide loans within a short period of time, mostly free of charge, and do not require any collateral. With regards to emergency loans of Rs. 5,000 respondents showed a much stronger preference for professional moneylenders such as pawnbrokers. As they explained, moneylenders do charge interest but they can make loans of this size quickly.

Chart 2: The Preferred Loan Sources at the Various Cash Shortages



In the category of Rs. 2,000, Dhanei KGFS also attracted many customers. Nearly as many respondents (23) mentioned Dhanei KGFS as their first source for loans of this magnitude as mentioned friends, relatives, or neighbours (26). Most of those who spoke of Dhanei KGFS were referring to the Hand Loan. (It is worth noting that disbursements under the Hand Loan were on hold at the time of data collection, possibly lowering the number of people who referred to these loans as their preferred source of emergency financing.) Respondents referred to the convenience of the loan, its availability at odd hours, and the fact that informal sources such as friends or neighbors would be hard-pressed to lend Rs. 2,000 at short notice. Additionally, the Hand Loan is also cheaper than semi-formal loans offered by professional money lenders. Finally, customers appreciated the absence of a collateral requirement. Professional money lenders would charge around 3 to 5 percent per month compared to the 2 percent charged by Dhanei KGFS, and also typically require a borrower to provide collateral.

Disbursal and Repayments

According to data on disbursals, 124 individuals took out a Hand Loan just once. As the following table shows, a number of people took out several loans. Of the 347 total disbursals, 16 were given out after 7pm.

Table 1: Take-Up Rates

Maximum Take-Ups	Borrowers
1	124
2	83
3	15
4	3
Total Borrowers	225
Total Disbursals	347

One of the main challenges of the product design is to avoid borrowers repeatedly renewing Hand Loans. Interestingly, 75 out of 102 customers who took up a second Hand Loan did so within two weeks after repaying the first one. All 18 customers that took up at least a third one did so within a week after they have repaid their second Hand Loan. Finally all three customers who took a fourth loan did so within three days after redeeming the previous one. These findings strongly suggest that a waiting-period between disbursements is needed to avoid transforming the Hand Loan into a kind of a credit line.

The underlying problem might be that some customers did not receive as much income as expected. Dhanei KGFS wealth managers interviewed about this issue had a similar view, observing that in many cases income does not seem to be sufficient to cope with both repaying the Hand Loan and meeting all current expenses. So borrowers may have used income to redeem the Hand Loan and then taken another loan soon afterwards in order to meet basic household expenses or emergency expenditures. It is also possible that some borrowers strategically planned to take a string of hand loans to extend the term.

At the time of writing, six out of 347 loans are still outstanding, indicating a repayment rate of around 98 percent. While the success criteria did not include an explicit quantitative target for the repayment rate, a rate of around 98 percent for a product in the pilot phase is quite promising. Furthermore, in interviews, wealth managers expressed the belief that at least four additional customers will repay their Hand Loans. Most of them were facing longer-term difficulties such as the death of a household member or severe illnesses that prevented them from repaying on time. If so, the repayment rate will eventually be more than 99 percent.

However, a successful product would not just be repaid but also repaid on time. The loan data provided by Dhanei KGFS indicates that 139 out of 347 (40 percent) loans were not repaid on time. A closer look at the data on late payments reveals that 91 of those who were late with their payments eventually repaid the Hand Loan less than a week after the deadline. In sum, 86 percent of loans were repaid within a week of the due date. These small delays suggest that many customers may simply have forgotten when the loan was due, and when paid a reminder visit

only two days before the due date, did not have enough time to come up with the necessary funds. People interviewed in depth did not mention using any aids such as calendars in order to help them remember the repayment deadline.

Evaluation Against Objectives

The Hand Loan has taken the place of some informal means of lending (e.g. pawnbrokers), that often charge high rates and require collateral that is sold if the loan is not repaid on time. One unexpected result was that it also provided an intermediary between some customers and loans from their employers that generally charge no interest and can be repaid in small installments.

The most common purpose mentioned by borrowers for using the product was meeting urgent health expenses. Not all such expenses are necessarily unexpected; illnesses and accidents are hard to foresee but the same cannot be said to childbirth. Nonetheless, a number of interviewees reported having used Hand Loans to meet childbirth-related expenses. Some interviewees mentioned education-related expenses, such as expenditures on school supplies or tuition fees, as reasons for borrowing. These too do not meet a strict definition of emergency. However, given the mostly inadequate savings devices available to low income households, even such “foreseeable” cash needs can become urgent. Other uses for the Hand Loan included paying utility bills, covering festival-related expenses and repairing wells.

During in-depth interviews, respondents were asked how they managed to repay the Hand Loans within a month. In most cases borrowers used cash from income to redeem their debts. They also relied on income from other household members in order to raise the Rs. 2,000. This suggests that people used Hand Loans in order to cope with short-term cash-flow shortfalls and did have the income necessary to repay the loan in a timely fashion.

However, during in-depth interviews, some people reported borrowing additional money from other sources in order to repay their Hand Loans. This was particularly the case if borrowers had jobs that guaranteed a consistent salary payment. In such cases, people often took cash advances against future salary payments from their employers and paid off the Hand Loan as soon as the advance was available. These types of loans are typically less harmful than other informal loans since they can carry no interest and are repaid in small instalments over a longer time period. Therefore, the Hand Loan can be used as a stop-gap for the short period of time that the employer takes to gather the advance funds. This outcome, though unintentional regarding the original design of the Hand Loan, is still a success from the borrower’s perspective since it helps them access the finances they need immediately and provides a bridge to cheaper loans that are easier to repay.

Evidence from the field also suggests that customers have come to appreciate Dhanei KGFS even more because of the Hand Loan. During an in-depth interview, a borrower explained that she had taken the Hand Loan to allow her to take her son, who had a fever, to see a doctor. Within 30 minutes and with hardly any paperwork she had obtained Rs. 2,000, which enabled her to see the doctor. It was this experience that made her say: “My opinion about Dhanei KGFS Bank has changed in the last six months. Initially I thought they are just another bank. However, now I know they really care for the people.” In a similar vein, a customer who used the Hand Loan four times in order to cope with various cash needs such as urgent life insurance bills or

health expenses, said that “Dhanei KGFS Bank does not only offer loans. They also offer Hand Loans which you can get even at night.”

Lessons Learned

For Design

The Hand Loan has gained a significant foothold in the local market for emergency finance, especially for cash shortfalls in the region of Rs. 2,000, where it is often customers’ first choice. However, emergency-loan seekers turn to other sources of finance if the cash shortage is significantly lower (e.g. Rs. 1,000) or higher (e.g. Rs. 5,000). This is no surprise, given that the Hand Loan product does not allow for flexibility in terms of the loan amount. Respondents mentioned Dhanei KGFS’ lack of Hand Loans with higher or even lower amounts as a reason for turning to professional moneylenders. Faced with a requirement for Rs. 500 or Rs. 1,000, they could borrow Rs. 2,000 and put whatever they do not need aside. Indeed, some did precisely this: one customer said that she decided to take out a Hand Loan to pay for her son’s visit to the local doctor even though she anticipated expenses much lower than Rs. 2,000.

Behavioral economics provides a clue as to why this is not what most people do. A person who borrowed more than they were immediately in need of would need to resist the temptation to spend the extra amount. Someone who was aware of his or her lack of self-control might therefore prefer not to take out a loan which would leave them with excess cash in hand. During an in-depth interview, one woman said that “You always end up spending the money that you keep at home.” This suggests that allowing Hand Loans for smaller amounts than Rs. 2,000 might spur higher take-up rates by drawing in people with self-control problems who face small cash shortages. Some borrowers may also be trying to avoid paying interest on funds they did not need.

The reasons for delays in repayment were also indicative of the need to refine the product. The data suggest that borrowers do not seem to be overestimating their repayment capacities dramatically. Rather, the problem may have been Dhanei KGFS’s having failed to communicate the ramifications of delays in repayment to customers and not sending payment reminders far enough in advance. If a customer did not repay on time, a penalty increased the costs of holding a loan from 2 percent to around 6 percent per month (instead of Rs. 40 per month an individual ended up paying around Rs. 125 per month.) Many customers shared the perception that a loan would cost Rs. 40 per month even if held for longer than four weeks. In these circumstances, customers were unlikely to strive to repay loans on time in order to avoid penalties.

For the Product Innovation Process

This pilot ran into many challenges but the ultimate results are quite instructive for future product innovation initiatives:

- ***Multiple iterations will be required:*** The first iteration will need to address a broad range of opinions about the best design, as limited evidence will likely be available. The results of the first pilot will not only back the design elements with evidence but will also surface unanticipated consumer behaviors and operational hiccups that can be solved in the next iteration.

- ***The need for short-term profitability can confound the design:*** It is challenging to get buy-in from management for products that are profitable only when part of a broader portfolio or in the long-run. Incentive structures may be set up in a way to discourage this type of innovation. Suggestions for changes to the design for profit motives may come disguised as intuitions about consumer behavior.
- ***Execution details are paramount:*** Every detail of framing and communication to the consumer is crucial to the success of the product. The process and initial results must be monitored closely to make changes along the way. For example, payment reminders could have been instituted earlier in this pilot had accurate data on the nature of late payments been available. Branch staff may fail to follow protocols for various reasons and any pilot must anticipate such problems. For example, branch staff refused to mention hand loan late payments during the same customer's Joint Liability Group (a debt taken on by a group of borrowers who have an equal responsibility) meeting for fear of embarrassing the customer and damaging the bank's relationship with her. The purpose of a relationship product is defeated if the customer sees no connection between it and the rest of her interactions with the bank.
- ***Successful designs will anticipate execution variances:*** Thinking through alternative scenarios for executing the product before implementation can be a useful way to refine the design to be more resilient to ground-level problems. Ideally, safeguards can be built into the product design. If that is not possible, monitoring triggers can at least be set up on key metrics such as delinquency and loan amount.

Future Improvements

While the Hand Loan has broadly succeeded in its original intent, it still has room for considerable improvement. Three main areas where the Hand Loan could be improved include: varying the amount, limiting the frequency of loans and improving communication between KGFS and its customers. These areas of refinement carry lessons for other products with similar goals to the Hand Loan. Simply addressing customers' behavior and trying to achieve profitability are not enough; the fundamentals of providing financial access should not be forgotten.

Making the loan amount flexible can meet a greater range of customer needs. However, smaller amounts put pressure on product profitability. A few alternative designs are possible; for example, a flat fee (which would vary based on the principal amount) could be charged instead of an interest rate. Extending that idea, customers could be charged an annual fee for receiving a token that would entitle them to a fixed number of one-month hand loans per year. To strengthen the relationship aspect of the product, the annual fee could be refunded to customers who maintain or increase the breadth and depth of their relationship with the bank.

In the next iteration, a waiting-period between loan disbursements needs to be tested to avoid customers in effect extending the term of their loan. On the other hand, the lack of a waiting period may have also avoided late payments by creating a way for truly distressed borrowers to extend the term. Potentially, the waiting period could be set as a default but waived at the discretion of a wealth manager. A waiver fee could also be used as a deterrent to frivolous term extensions.

Emergency Hand Loan

While most customers repaid the loans on time (86 percent paid by the due date or within a week late), payment reminders did not occur until two days before the due date. Dhanei KGFS has agreed to test reminder phone calls, which are significantly cheaper than personal visits. Given that around 80 percent of the customers possess mobile phones, phone calls or SMS reminders are quite feasible. Whether via phone calls or personal visits, reminders 15, 22 and 25 days after take up may spur more timely repayments.

In addition to the lack of sufficient reminders, many customers did not seem to be aware that delays in loan repayment would incur a significant cost. Once customers learned “painfully” about the penalty for late repayment; however, the evidence suggests they then pay back the loan quickly. Therefore, a re-launch of the product requires successfully disseminating information about the penalty fee.

Dhanei KGFS is keen on continuing the use of the Hand Loan with some changes to the design. This will most likely entail a similar product approval process as the pilot phase. The next iteration of the Hand Loan will be tested with many of the enhancements described in this section balanced against over-complicating the product and process. The fee-based pricing design enhancement should also make the product more financially sustainable without over-burdening customers. There is no evidence that other microfinance institutions in the region have adopted a similar product. While these institutions tend to avoid lending to individuals, they would be more likely to adopt such a product if it were proven sustainable. Adapting the design and implementation for future iterations should help determine this.

2121 Pennsylvania Avenue, NW
Washington, DC 20433, USA
www.ifc.org

