How to address over-indebtedness of microfinance clients?

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What do we mean by „Over-indebtedness“?

- There is no unique definition of over-indebtedness
- Over-indebtedness is and will always be part of lending
- But it becomes a problem if it **systematically affects a broad range of microfinance customers**
- Over-indebtedness gets even more problematic with the changing definition of microfinance from
  - “income generating tool to overcome poverty” to a more broader definition of
  - “demand oriented provision of financial services (‘financial inclusion’)”
  - Then what is the value added of microfinance?
- A proper definition over-indebtedness is difficult …
What do we mean by „Over-indebtedness“? (cont’d)

- From a customer perspective:
  - very broad definition: when he/she is worse than without the loan (negative impact)
  - or more specific: when the client cannot repay the loan („over-borrowing“)
  - however: no consensus about „manageable level of debt“ in developing countries

- From an MFI perspective:
  - when clients don't repay (= increase in defaults), but:
  - especially in microfinance, defaults are due to many reasons, not only over-indebtedness: strategic default is no sign of over-indebtedness
  - customer in fact ends up with more money
  - fast growing MFI have „hidden defaults“ because new customers bias the portfolio quality towards the better
  - non-defaulting customer does not imply that he/she is not over-indebted
  - permanent „juggling“ of different debts either disguises over-indebtedness or MFIs see it only very late in their increased delinquency
What do we mean by „Over-indebtedness“? (cont’d)

- Hence:
  - From customer perspective very weak definition
  - But defaults are not an appropriate indicator to measure over-indebtedness either
  - This makes the topic difficult for practioners and regulators
  - Regulators therefore needs to define „over-indebtedness“ from a customer perspective and in the local context
Factors contributing to over-indebtedness

1. External factors
   - Adverse shocks
   - Institutional environment (e.g. macroeconomic or legal)

2. Lender behaviour
   - Marketing and growth focus
   - Inflexible products
   - Unfair lending procedures / collections

3. Borrower behaviour
   - Cognitive and psychological biases
   - Sociological influences
   - Socio-demographic / economic attributes

Over-indebtedness as a consequence of interacting factors

Shicks.2010. Microfinance Over-Indebtedness: Understanding its drivers and challenging the common myths. Page 15
Factors contributing to over-indebtedness (cont’d)

- **Borrower behaviour**
  
  “Protecting borrowers from over-indebtedness may mean protecting them from themselves“

- **Cognitive and psychological biases**, e.g.
  
  - *over-confidence bias*
  
  - *Availability heuristic* (underestimating probabilities of events one rarely experiences)
  
  - *Habit persistence* (reducing consumption too slowly in adaption to income flucutations)
  
  - *Short-term bias* due to permanent state of precarious situations

- **Sociological influences**
  
  - Inequality and social comparison: desire to keep up with consumption levels of peers

- **Socio-demographic attributes**
  
  - Low levels of „debt literacy“ (financial literacy)
  
  - Social obligations to support relatives and neighbours at any cost
Factors contributing to over-indebtedness (cont’d)

Lender behaviour

- **Irresponsible lending procedures**
  - Under-estimation of debt load for borrower (assuming that loans would substitute informal loans, but in reality they **add on** to informal loans)

- **Excessive marketing and growth focus**
  - Incentive for FOs schemes based only on quantities, not quality (e.g. loan portfolio)
  - New staff is not always in a position to handle in a socially responsible way

- **Unsuitable products**
  - Trade-off in frequent repayments:
    » Serves as early warning system for field officers and encourages customers to pay regularly
    » But: if micro credit is only for income generating activities, the time for the investment to have returns is very short
  - Loan sizes: Over-borrowing can result from too high loans or too small loans! (in high competitive environments)
Country cases studies of over-indebtedness

Bolivia and Bangladesh during the 1990’s

- **Aggressive consumer credits in Bolivia (late 1990s)**
  - A Chilean finance company very aggressively entered the market with consumer credits
  - In 1999 BancoSol lost 11% of its clients and overdue rates fell from 2.4% to 8.4% within 2 years
  - Borrowers took multiple loans simultaneously from different lenders, causing over-indebtedness and “loan juggling” for repayments
  - Solution improved when regulations tightened and the finance company left the market

- **“Overlapping” in Bangladesh (mid – late 1990s)**
  - Mid and late 1990s Grameen Bank, ASA, BRAC and Proshika grew strongly
  - Despite informal agreement among them to avoid multiple lending to same clients, exactly this happened
Country cases studies of over-indebtedness (cont’d)

- Hence:
  - Competition has positive and negative effects
  - Borrowers with loan options from multiple lenders tend to have less financial discipline
  - Informal agreements between lenders seem not necessarily to work in high-competition environments
  - Cooperative behaviour can mitigate such problems with support from a credit information bureau
How to avoid over-indebtedness

Transparency and disclosure
- Surveys show that clients under-estimate the costs of borrowing
- Interest rates need to be calculated in the same ways
- More than 70% of countries have interest ceilings and require disclosure
- In South Asia and Africa only half of the countries have disclosure requirements
How to avoid over-indebtedness (cont’d)

**Interest rate ceilings:**
- Results of interest rate ceilings are less effective than disclosure requirements
  - Interest rates are not smaller in countries with interest rate ceilings
  - Low income quintiles get disproportionately worse affected due to credit shortage

**Loan sizes:**
- In some countries regulators prescribe limits in loan size per borrower
  - e.g. monthly repayment not to exceed 30-50% of net monthly income
  - However are difficult to enforce and easy for lenders to circumvent

**Repayment frequency:**
- Allow certain flexibility in repayments, e.g. in case of external shocks
Taking a fresh look at Sri Lanka

- **Transparency and Disclosure:**
  - Interest rates are calculated in different ways
  - Fees are usually not shown

- **Competition:**
  - Microfinance sector has a huge outreach, very similar to Bangladesh
  - Commercial interests are increasing
  - Some MFIs are growing strongly
  - No Credit Information Bureau for Microfinance existing
  - Certain “overlapping” existent,
    - particularly in rural areas: about 22% of customers access two or more different institutions for loans (however does not include informal credit)
    - Loan amounts in rural sector relatively small (Samurdhi Bank, Co-operatives and RDBs). Are loan sizes too small in rural areas?
    - Geographically: especially in North Central, Central and Sabaragamuwa
    - Especially second and third income quintiles affected
Taking a fresh look at Sri Lanka (cont’d)

Percentage of borrowers with access to two or more financial institutions in Sri Lanka

Taking a fresh look at Sri Lanka (cont’d)

- **Financial literacy among borrowers:**
  - So far there is no survey about the level of financial literacy
  - Positive aspect: literacy in general is relatively high

- **Hence:**
  - There is no immediate threat of over-indebtedness in Sri Lanka
  - But there are some signs that the issue should be taken serious
  - Regulator can provide positive input through
    - Pragmatic disclosure requirements
  - Practitioners can provide positive input through
    - Responsible lending and collection practices
    - Suitable product development: e.g. cash flow based lending
    - Participation in credit information bureau
THANK YOU!

You will find the presentations and outcomes under www.microfinance.lk