When is Microcredit Unsuitable?

Insights from financial diaries of over-indebted borrowers

Working paper available at bit.ly/unsuitablecredit

Motivation

- Unsecured lending to low-income households is:
  - Nearly ubiquitous (JLGs active in 566 of 676 districts)
  - Large and growing market (Rs. 1.4 trillion in FY 2016), further boosted by policy initiatives
  - Dominates LIH’s formal financial interaction (both in terms of portfolio composition and active use)
- Our research objective: To identify (and prevent) unsuitable lending decisions in microcredit
  - Unsuitable = substantial financial distress as a result of use/servicing
  - Customer’s financial situation x product features
  - Specific recommendations on underwriting, lender practices and regulation
- From a HFR perspective
  - Is an unsuitable loan a “mistake”?
  - Is current regulation effective at preventing mistakes and/or minimizing their consequences for LIH?
  - Credit mistakes pose an enormous threat to both borrower well-being and market stability

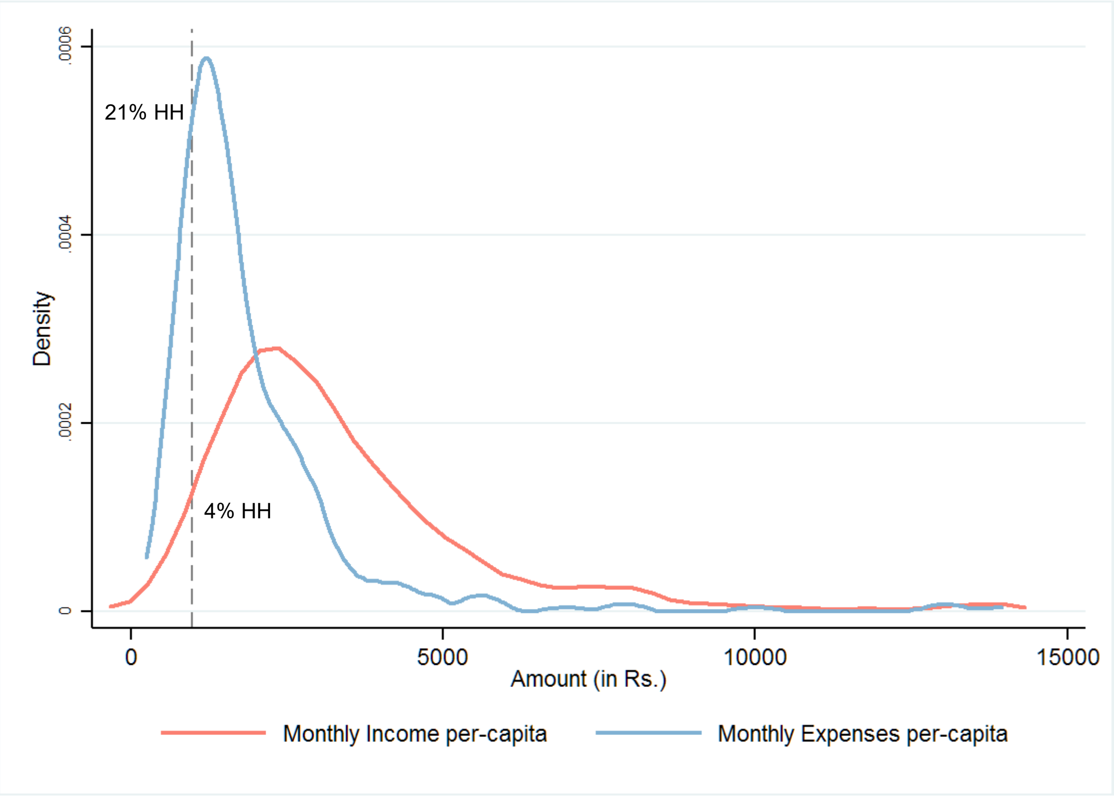
Characterizing unsuitable loans as financial mistakes

- Can now confirm heterogeneous impacts of access/use of new credit
  - Average treatment effects of credit access on well-being are **not** significant
  - Truly transformative impacts are significantly mediated by loan use, borrower characteristics such as entrepreneurial qualities, prior credit/ formal experience, risk tolerance and overall community characteristics
  - No clear understanding yet of who tends to be worse-off from more credit
- Harmful consequences of over-indebtedness are well documented
  - Different experiences of transitional vs. persistently over-indebted borrowers (Guerin et al. 2013)
  - LIH revealed preference for positive coping mechanisms but higher use of negative (Gash and Gray 2016)
  - Beyond loan amount, specific features of credit contracts x borrower characteristics can cause distress (Venkata et al. 2010 and Field et al. 2012)
- Credit mistakes are not easily observable, esp. in group lending
  - Lending/collection practices systematically emphasize timely repayments and intra-community smoothing, while incentives for frontline staff may discourage reporting of repayment difficulties even where this data is captured in MIS

Data collection

- 12 month panel survey of 400 low-income households in Krishnagiri district of Tamilnadu
  - Medium-high access environment with ~100% access to savings accounts and active lending by several banks, RRBs, SHGs, MFIs, other NBFCs
  - Monthly financial diaries tracking occupations, incomes, expenses, loan repayments, new loans and social network transactions
  - Median household monthly income was Rs. 12,773 and typically came from multiple sources; More than 60% HH had atleast one salaried source but for most their primary and dominant sources were casual wage or self-employed occupations

Distribution of living standard, as measured by per-capita income and expenses

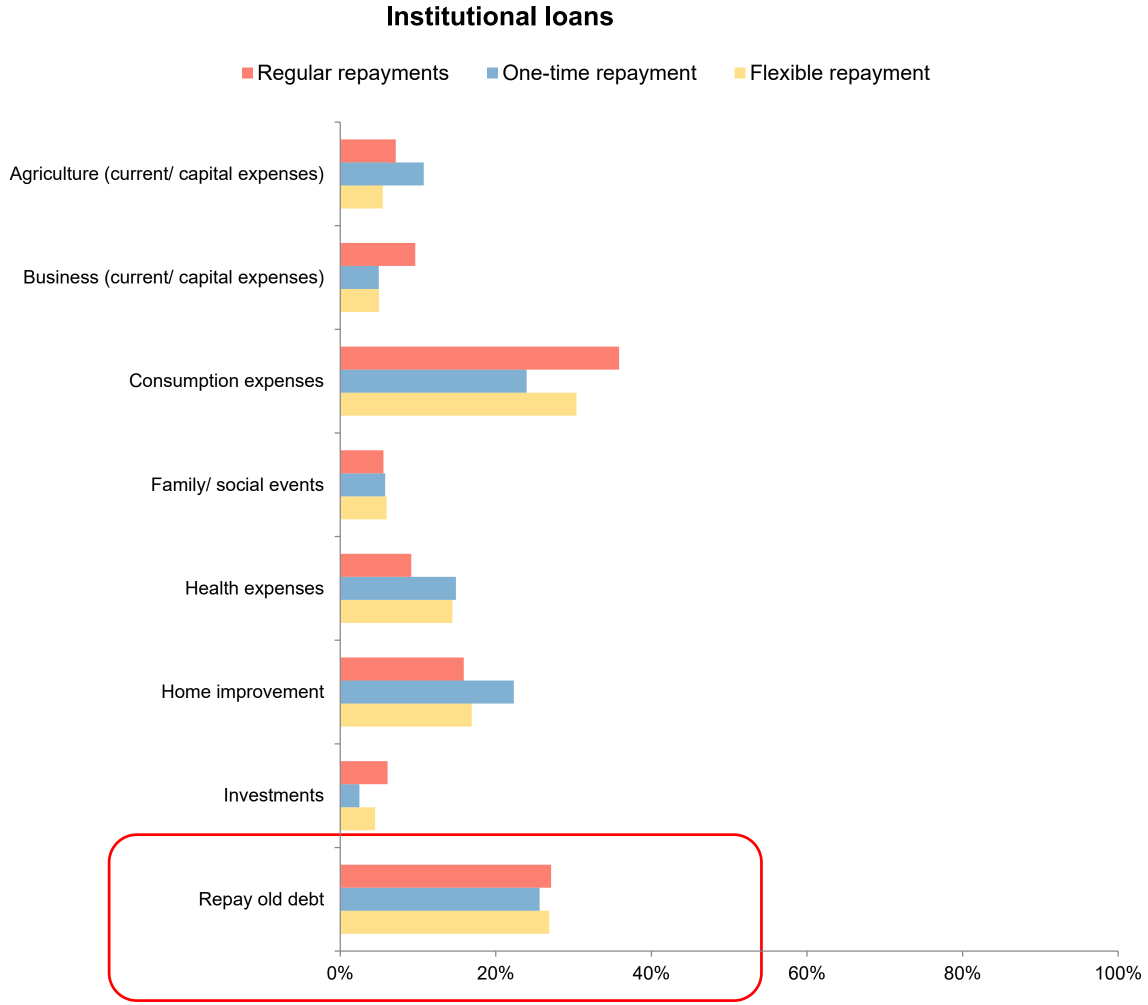


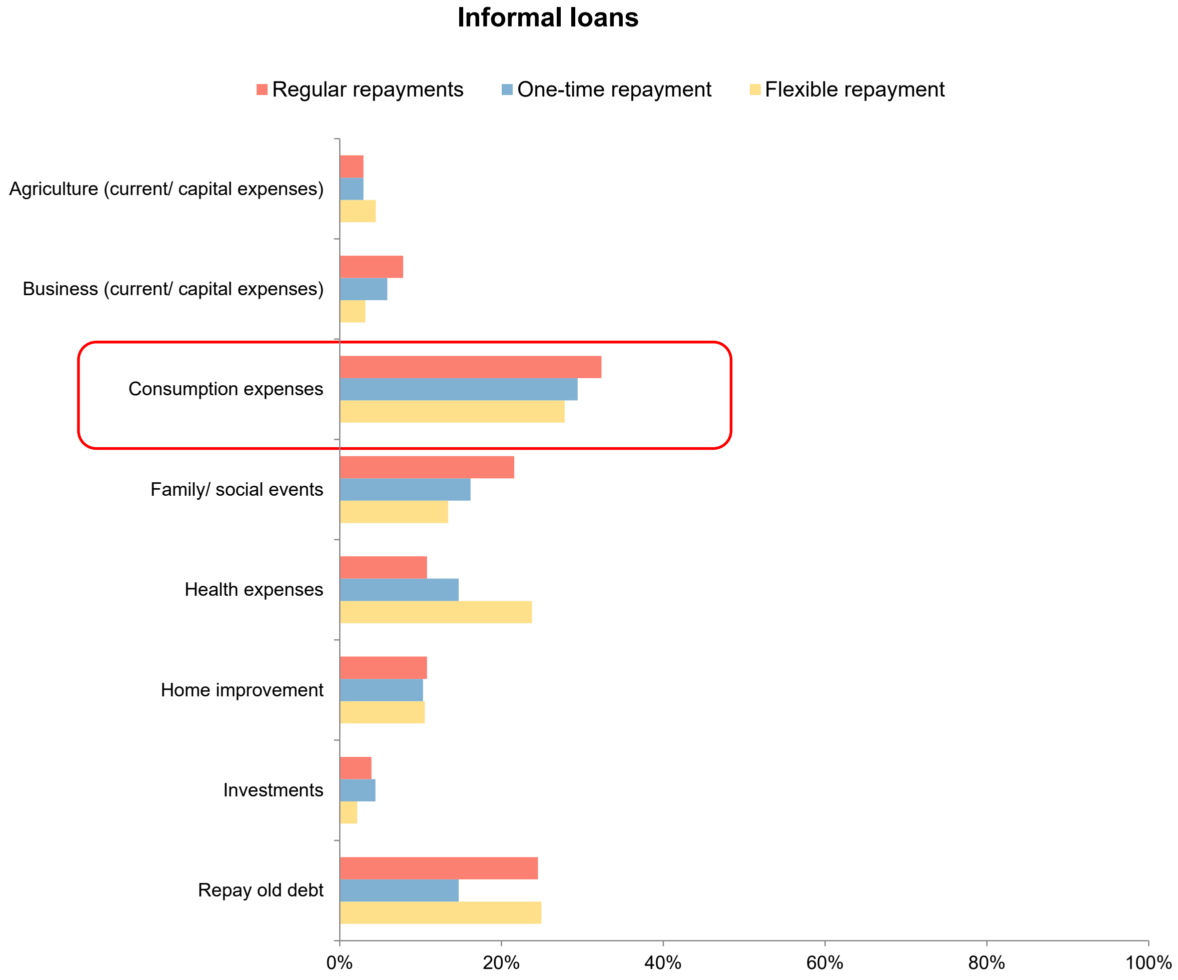
Features of credit contracts

	Kin	Non-kin	Bank	Co-op	MFI	SHG
Access & Use	33%	61%	37%	14%	50%	38%
Loan principal (in Rs.)	18,000	10,000	50,000	27,000	22,000	30,000
Type of collateral given						
Immovable property			3%	4%		
Movable property			3%	10%		
Gold, ornaments and jewelry			53%	50%		
Shares			30%	25%		
Others, including documents			10%	10%		
Repayment frequency						
Fixed, at regular intervals						
Weekly	1%	3%	-	7%	4%	1%
Monthly	7%	7%	30%	14%	45%	43%
Others	8%	11%	31%	32%	49%	54%
One-time payment	8%	10%	20%	28%	-	-
Whenever money available	73%	67%	18%	19%	1%	2%

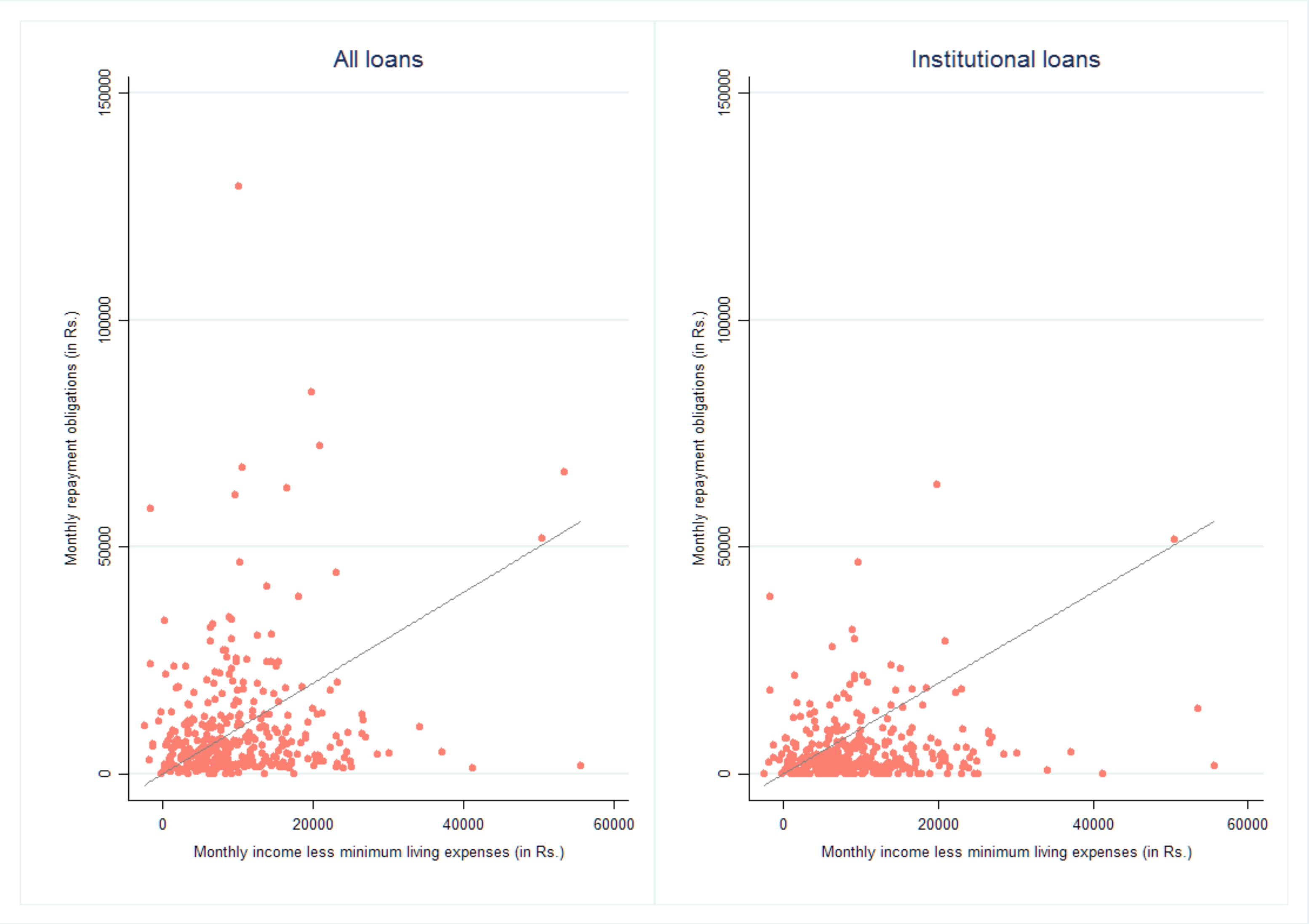
Result 1. Liquidity management as primary use of loans

- Large proportion of loans in sample used to either manage loan repayments or overall household expenses
  - Use of loans for liquidity management is positively correlated with the level of indebtedness





Result 2. Unaffordability of overall debt burden



- 21% HH carried unaffordable institutional debt
  - As many as 85% borrowers with extremely unaffordable debt did not miss formal loan repayments
  - Unaffordability correlated with incidence of negative coping mechanisms– borrow to repay, lower consumption, dependence on social networks transfers
- Credit as primary coping mechanism vs. savings-led smoothing/ insurance
  - How were loans easily available even to over-indebted borrowers?

Result 3. Errors in assessments of borrower's eligibility as cause for mis-sale

- Harmonizing credit bureaus can prevent false positives, but creates a lot of false negatives– greatly limiting access to credit and opportunities for upwardly mobile households.

Type of misclassification	% MFI clients in sample
False positives	
Compliant as per MFI-only bureau, but not including all formal loans	33%
Compliant as per MFI-only bureau, but not as per debt servicing capacity	21%
Compliant as per combined bureau data, but not as per debt servicing capacity	6%
False negatives	
Non-compliant as per combined bureau data, but having surplus debt servicing capacity	21%