Over-borrowing and competition: Are credit bureaus the solution?

Will over-borrowing by microfinance clients result in higher default rates? Should the microfinance sector be concerned? Is credit bureau the solution? In this article, Karuna Krishnaswamy raises these and many more questions. The article discusses the state of competition between MFIs and multiple borrowing by microfinance clients in India. It draws from a preliminary research study to find a solution.

In the past few years, Indian microfinance has seen unprecedented growth. For instance, during 2005, major Indian microfinance institutions (MFIs) were able to expand their active borrower base by about 110 per cent making the sector one of the fastest growing world wide. Loans outstanding of Sa-Dhan's members almost doubled from Rs 1095.1 crore to Rs 2070.2 crore from 2005 to 2006. In fact, in 2005, five leading MFIs from India ranked in the list of top 20 fastest growing MFIs in the world[1] . This trend was reinforced by and in turn further accelerated the commercialization of the industry. Commercialization is characterized by increased competition for clients and an objective to seek profitability. A majority of the top 25 MFIs in the country are either profit-oriented NBFC–MFIs (Non-bank finance company–microfinance institutions) already or planning on becoming one.

Despite the growth, there is considerable unmet demand in India. According to a World Bank report[2] , only 9% of poor families in India are covered by microfinance. Of the projected credit requirement of US$ 10909 million, only US$ 1050 million is met by microfinance. Although this demand is widespread, MFIs are not evenly distributed geographically. MFIs are clustered primarily in the south, with two-thirds of all microfinance clients being in the southern states of Andhra Pradesh (AP), Tamil Nadu (TN) and Karnataka. Interviews with about twenty sector experts and practitioners suggests that fast-growing MFIs tend to expand to areas where there is already an incumbent, similar to banks which tend to open new branches in more financially developed areas[3] . The reason for this strategy is to leverage training and screening of client by the incumbent MFI and general awareness of microfinance in the area. MFIs in India, by and large, do not distinguish themselves by geographic areas or by offering differentiating products to different client segments. The above reasons have lead to competition for the same clients in many parts of the country including AP, Karnataka, MP, WB, UP, Orissa, TN and Chattisgarh.

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MFI competition – what's good, what's not?

In general competition can be beneficial to MFIs and clients. MFIs improve their product lines to meet client demands; prices become lower; the quality of services provided improves; and overall, MFIs become more client-driven. In terms of governance, MFIs become more efficient and conscious of risk management issues. The effective interest rate charged is often made more transparent. Better governance complements commercialization of the MFIs. Banks and other private investors feel more comfortable investing in well-managed MFIs that adopt good governance practices. As a result, such MFIs enjoy continuous inflow of funds that makes further outreach of clients possible. Indian MFIs lead the way in access to commercial funds with a commercial funding ratio of about 75 per cent.

However, a review of the literature in

other countries and interviews with leading practitioners reveal the negative aspects of competition. There are sector-wide concerns about unethical client and staff poaching, violation of the 'code of conduct' and reckless lending without suitable assessment of clients' repayment capacities by some fast growing MFIs and increase in multiple borrowings. Furthermore, recent trends in commercialization have given rise to the apprehension that social objectives of microfinance - to provide a means for poor to improve their livelihood through financial inclusion - is diluted by targeting richer clients to increase profits, the so-called "mission drift".

The information dilemma– what is the truth?

Multiple memberships have critical importance to MFIs and the industry as a whole because it is an issue that inevitably arises in the evolution of microfinance in more mature and competitive countries like Bolivia, Uganda and Bangladesh. It is considered to cause over-indebtedness among clients and deteriorate repayment rates. Theoretically, competition and multiple memberships, without sharing of client repayment information between the different lenders, lead to weakening of the incentive of the client to repay since if the first MFI denies further loans to the client, she has outside options now[4] . While the sector in India and throughout the world have grave concerns about unregulated competition and multiple borrowing, this stance is not consistently supported by rigorous evaluations (of which there exist only a few in the literature) using large data sets which suggest that the effects of competition and multiple borrowing are not as deleterious. Due to unavailability of primary data, the extent and impact of the phenomenon of multiple borrowing especially in India has been gauged by surveys which are constrained by small sample sizes and the dependence on self-reporting by the respondent.

The Centre for Micro Finance (CMF), Chennai, India has conducted a study on the subject in order to address this lacuna in the literature on competition and multiple borrowing. The scope of the study includes a literature review of issues related to rapidly intensifying competition in the microfinance sector in the most competitive markets in the world. Further CMF conducted interviews with leading practitioners and sector consultants on the extent of competition in India and consequences for the borrower, the lender and the industry as a whole. Using a new large data set of loan records of ICICI's partnership model clients from seven selected MFIs in a competitive state in India, the study aims to quantify the prevalence of multiple memberships across these MFIs by matching clients across these MFI records. The study compares the repayment performance of borrowers who have a single membership with those that hold multiple ones. Trends of repayment are plotted across geographic areas experiencing varying competition intensities. The study complements the quantitative results with a qualitative report based on interviews with selected multiple borrowers who have been identified in the data set.

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Multiple borrowing and repayment – is there a connection?

The key finding of this study is that there is no negative relationship between multiple borrowing and repayment performance. In fact, over a 3 year time frame of loan disbursal records, multiple borrowers had a lower or equal arrears rate than their single borrowing counterparts in the same villages or colonies, which in turn was lower than the overall arrears rate of all clients in the sample. A majority of the multiple borrowers interviewed reported that they used the second loan for investment purposes and none had repayment difficulties. Analysis of the average number of days elapsed between multiple loans, and their stated loan purpose as listed in the data was performed, but this did not shed further light on what the motivations for taking multiple loans could have been.

Compared to the overall arrears rate, all the MFIs, except one operating in urban locations only, had equal or better repayment rates in more competitive branch locations (defined as villages with at least 3 MFIs with multiple borrowers) than otherwise. While this by itself does not imply that competition improves repayment — more rigorous examination is needed to evaluate that - it appears that MFIs are, by and large, managing risk well in the face of competition at this point. There is a perception in the sector that new, fast growing MFIs, when they move to an area with an incumbent MFI, use larger (than currently taken with the incumbent) loan size as a client poaching tool, thereby disregarding the Grameen model's traditional practice of gradually increasing. There was no strong evidence to support this. Furthermore, clients of fast growing MFIs had the best repayment rates and the highest percentage of multiple borrowers.

There is a fair degree of collective behavior in multiple borrowing and in defaults in general. A group member is likely to know about her partners' multiple memberships. We find that in our data, in centers where there was at least one multiple borrower, between 9 and 15% of the members of the same center are also multiple borrowers. Interviews with multiple borrowers revealed that multiple borrowing is done with the knowledge of many of their group members and loan officers and there is even collective dual membership at the group level in some cases. As regards defaults, in 3 MFIs, centers where there was at least one defaulter had a total of between 22 and 44% defaulters.

None of the multiple borrowers interviewed had been poached by an MFI – it was a voluntary decision to gather more credit. Based on their repayment performance as per the data and the interviewees' unanimous desire for larger loan sizes, it appears that credit rationing is occurring. Each individual MFI is offering less credit to multiple borrowers than what she wants and is able to repay.

Can credit bureau be the solution?

There is no evidence to justify a credit bureau for the sector, at this point, if identifying multiple borrowers to prevent repayment from suffering is the main goal. It does appear that peer and staff monitoring

and informal information sharing about multiple borrowing is prevalent. Both group members and loan officers have good knowledge about the clients' activities and are better able to monitor that the loan has been used for the stated business activity. While a cost-benefit analysis needs to be done in this regard, the findings confirm the judgment of some of the sector experts interviewed that at least for the next 10 years, loan officer and peer monitoring is more effective and cheaper than a credit bureau, particularly in rural areas.

However, the group behavior noted above gives some room for concern. The microfinance clients in a center act as a collective. MFIs are particularly prone to large scale defaults or late payments in the event of an adverse economic shock or recession. As we have learned from Bolivia, macro-economic business cycle downturns exacerbate repayment deterioration and it is important to have a good risk management strategy in place.

A credit bureau could be justified on the grounds of being able to view clients' past credit histories to discern between different types of clients and if possible to differentiate between distress and opportunity-driven borrowers. It could be used to target different client groups with customized products, terms, loan sizes and interest rates. It could avoid cross-subsidizing high risk borrowers by low risk borrowers if differential interest rates are offered to each type of client. A bureau could also improve loan approval times and improve efficiency .5 ■

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This study is intended to be a first step in motivating further rigorous research into this subject. CMF has presented this report at its autumn conference on September 21, 2007, followed by a panel discussion by leading practitioners and sector consultants on the above issues, in particular, on mission drift, competitive practices, multiple memberships and the case for a credit bureau.

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3. Pande, R. and Burgess, R., "Can Rural Banks Reduce Poverty? Evidence from the Indian Social Banking Experiment.", American Economic Review, 2005
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ERRATA
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Though we spent considerable effort attempting to ensure the correctness of our publication, a few typographical and other errors are bound to have escaped the review process. This section corrects those mistakes and omissions. The editorial team apologizes for some inadvertent errors in the last issue.

In the cover story titled Microfinance Valuations – Chimera or Science, the authors would like to acknowledge the support of Anirban Gongopadhyay in researching and compiling the article.

The feature 'Franchising microfinance – Leveraging capital markets' was originally written by Francisco Perese. At the time of writing the article, Francisco was completing his internship at Intellecap.

Send additional errors and comments to,
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