QFINANCE

# Rigidity in Microfinancing: Can One Size Fit All?

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## Executive Summary

- Despite rapid growth in outreach, microfinance providers often have yet to reach a large proportion of the market of poor households.
- One explanation may be that microfinance practitioners have been slow to implement innovations to the standard lending methodologies.
- By tailoring products to clients' needs and repayment capacity, flexible microfinance has the potential to reach many more clients at lower cost. This can be proven with randomized evaluations of flexible lending contracts.
- Further work is needed to understand how this will impact on clients.

## Introduction

In the span of a single decade microfinance has gone from being virtually unknown—to bankers, to development workers, and, most of all, to the poor—to being a household word. Ask anyone today to describe microfinance and most likely you will get a common answer: "That's when banks lend to groups of poor women to start little businesses." Much of this increase in awareness is thanks to the tireless work of industry advocates who have traveled the world convincing development organizations and funders that microfinance offers the best hope for large numbers of poor families to move out of poverty.

Practitioners, broadly speaking, have been offered three choices:

1. Grameen Bank-style solidarity lending, with 12-month loans offered to groups of five poor women;
2. FINCA-style village banking, with a four-month loan divided among a larger group of about 30 poor women; or
3. ACCION-style individual lending to the moderately poor.

On most other features, these options are strikingly similar. All three target entrepreneurs with capital for sewing machines, chickens, tortilla presses, and the like. And all emphasize operational efficiency through product standardization, and good repayment through frequent regular payments that start shortly after the loans are disbursed. Here we discuss ideas that can be seen as "tweaks" to the above standard models. These tweaks increase the flexibility with an aim to improving the quality of the service received by the client.

## Lending Flexibility

### Problems with the Standard Model

Looking back on the evolution of microfinance one begins to wonder if perhaps its advocates might have been too successful in their messaging. By sticking to this script, the industry may have stifled creativity and individualism in the development of financial services for the poor. Consider the repayment schedule adopted with near universality for group-lending clients: weekly payments that start only one or two weeks after disbursement of the loan. This despite the fact that microfinance institution (MFI) managers are well aware that most of their clients' enterprises will not start generating returns so rapidly.

Why is this important? Being poor is not just about having too little income—it is about having an insecure income. The income of the poor can vary dramatically from day to day, month to month, season to season. The poor have good weeks and bad weeks. But microloans, like all loans with fixed repayments, are made on the basis of the borrower's ability to repay in their *worst week.* Otherwise they would end up in arrears at some point during the loan cycle. This rigidity has several ramifications. First, by basing borrowers' repayment capacity on bad weeks, instead of average weeks, it greatly limits the size of the loans the poor can borrow. If I earn 50 rupees some weeks and 550 rupees other weeks, my debt capacity is not based on my average income of 300 rupees but on the 50 rupees that I can afford to pay in the bad weeks. As a result, borrowers with variable income and little recourse outside of money lenders to smooth that variability will be given a debt capacity that is much lower than ideal.

Second, it may screen out many potential borrowers entirely: for example, any entrepreneur who pictures a week in which she might have slow sales or a household emergency. Or existing clients may leave because they experience too many "close calls" and then drop out to avoid going into default. Incidentally, these should be the bank's best customers—they are clients of such strong integrity that they refuse to borrow for fear of defaulting! Third, it precludes potential innovations like bullet loans for agriculture (a bullet loans is a loan where payment of the entire principal of the loan, and sometimes the principal and interest, is or are due at the end of the loan term).

These limitations help to explain why, despite years of growth, MFIs still fulfill only a small fraction of the financial needs of the poor. This year the Microcredit Summit Campaign has reported that its members reach a total of 150 million borrowers (Daley-Harris, 2009). This is a stunning achievement, and yet only a dent in the estimated two billion households that lack access to financial services. The need to identify ways to reach this market with appropriate financial services cannot be ignored.

## How to Be Flexible: Some Suggestions

How can we practically implement flexibility in the current structure of microfinance? A full portfolio of flexible financial products has yet to be developed, but there are some promising ideas. We give three examples, each highlighting a different element of flexibility. First, we observe that flexibility can be *prebuilt* into the contract. For example, in India the monsoon is a difficult time for everyone. Contracts could reflect this by reducing payments during this period in a prespecified manner. Similarly, dairy farmers face two months a year without milk. Again, the contract could prespecify a smaller loan payment during this period. Prespecification of flexibility has many benefits. Notably, clients are not led to believe that they can negotiate down other payments. The flexibility is not after-the-fact. It is actually a "rigid" flexibility, with tightly delineated rules. As a result, it also eases technological and logistical concerns of management information systems, cash management, and loan officer fraud.

Second, one could provide a less rigid flexibility by prespecifying a number of low payment periods, but not their timing. For example, one could give clients several tokens and tell them that each token can count for one weekly payment. In this way, the client agrees to a slightly higher payment each week in return for getting a few difficult weeks—of their own choosing—off. Again, the creation of a token ought to ease the logistical problems of MIS, cash management, and fraud. Yet it still provides the borrower with a great deal of flexibility.

Finally, consider an MFI that feels that its borrowers could handle 2,000-rupee larger loans than they currently receive. Should it just increase the initial loan size? What if instead it told all borrowers that they would be eligible for a second 2,000-rupee loan at any point during the cycle? This second loan might actually help the client more than simply increasing the initial loan by 2,000 rupees since it gives the client a safety valve in case of emergencies.

## Why Have People Been Afraid of Flexibility?

Fixed-debt contracts may be problematic, but there are sensible reasons for using them. First, a flexible payment stream may generate many operational headaches. For instance, portfolio monitoring requires clear information on default status. It may be difficult (or impossible) to distinguish between someone exercising their flexibility and someone who is intending to default further. The faster lenders deal with default, it is often believed, the better they are able to recover the loans. Furthermore, depending on how the flexibility is structured, it could cause confusion in the field. It is easier to train staff to collect equal and constant weekly payments. The flexibility should be such that staff can easily understand and implement it.

Second, cash management problems may arise. If clients experience correlated shocks (for example floods or droughts), they may (should!) use the flexibility to help smooth out those shocks. This has implications for the lender if it is seeing a shortfall in repayment at the exact moments it wants to have more cash on hand to lend to individuals. Third, flexibility may put the lender at risk of loan officer fraud. The loan officer, for instance, could claim that the client exercised her "flexibility" when in fact she repaid. (As noted above, this can be mitigated by prespecifying the payment schedule: if the client is expected to pay 50 rupees in a given week, the MIS will raise a flag if any other payment is recorded.)

Last, varying contracts might weaken the repayment discipline of borrowers. Some argue that the key difference between debt programs and savings programs is that debt provides a commitment to make weekly payments, whereas with savings there is no such commitment. Thus, this is one reason why rotating savings and credit associations (ROSCAs) and chit funds exist, to provide individuals with a commitment to save. If the debt requirement allows some flexibility, some fear that this will erode the repayment discipline. Borrowers may forget which weeks to pay and which not, or find it hard to turn on and off the habit of putting money aside to pay the loan. Either way, the fear is that having a few weeks off will lead to lower repayment when the payments are required.

These costs of flexible contracts are often better articulated than the benefits. Yet qualitatively the benefits could be huge. Will these products work? Will operational hurdles prevent them from working? Will they erode repayment discipline and increase default? Or will they allow for much larger loan sizes and greater client income growth? We simply do not know. A common retort is that borrowers can use other sources of income or debt to fill in the gaps. This misses the basic point about the financial policy for the poor: these alternatives either do not exist or are very expensive. Why cede this important and potentially lucrative financial service without ever testing the water? There is only one way to know if microfinance can be more flexible: by testing. As with any new idea, there is no way to know how well it works without careful experimentation. As we note above, the point is not that flexibility will impose no costs on the organization. Flexible products may be trickier to implement, or they might have ambiguous effects, like increasing portfolio-at-risk while increasing profitability. The challenge for MFIs is to find those aspects of flexibility which can expand their reach and impact without hampering continued growth.

To examine these theories in a practical way, at Innovations for Poverty Action (IPA) we use randomized control trials to test new products and services for the poor. To determine whether the benefits of a new idea outweigh its costs we measure its impact, benchmarked against the traditional methodology.

## Flexibility Works: Some Examples

### Group versus Individual Liability

For years a central part of the conventional wisdom of microfinance was that microfinance worked because of group liability: banks could safely lend to poor borrowers with no collateral because they would guarantee each others' loans. True, repayment rates among microfinance clients have been impressive. But, like the inflexible repayment schedules, there may be costs as well as benefits: How many potential clients might be deterred by the group-liability contract? How many don't borrow because they don't want to be responsible for other people's loans? We used a randomized control trial to measure the effects. Working with a rural bank in the Philippines, Giné and Karlan (2008) randomly selected groups of their microfinance clients to switch from group liability to individual liability, with all other aspects of the loan contract remaining constant. Following up three years later, the authors found no increase in default among individual-liability clients. On the other hand more clients had joined the individual-liability groups, suggesting that on average clients much prefer individual liability. In an expansion of that study, the authors tested with new clients by randomly marketing in some villages individual-liability loans, and in other villages group-liability loans. Again, there was no difference in default. The bank officers were much less willing to make individual liability loans, suggesting that the flexibility was perceived as too much for their staff, and they restricted the supply of credit. Whether it was right or not we cannot tell, since we do not know whether those not approved for loans would have defaulted or not.

### Repayment Frequency

In another study that tested one of the key assumptions of microfinance contracts, Field and Pande (2007) experimented with altering the frequency of payments, from weekly to monthly. After one year, they found no change in default. This simple test has vast implications: if clients can meet far less often with no effect on repayment, MFIs can drastically reduce their staff costs. Those savings can be passed along to clients, potentially making credit more affordable to the poor. And more clients may join if there's less of a burden on their own time. Naturally, more time may yield different results, and proper testing and patience can help us to learn the answer to these important questions.

## Evaluating Flexible Contracts

This same type of analysis can be applied to carefully examine the flexible lending contracts we describe above. In each case a (randomly selected) group receiving the innovation would be compared to clients offered only the traditional contract. The analysis can go much beyond simply "does it work?" The treatment and control groups can be evaluated on any number of dimensions: repayment, client retention, MFI profitability, etc. For example, flexibility might actually *save* on loan officer time. If every monsoon we know that clients have a tough time paying, might it not be more cost-effective to have lower or less frequent payments during that period rather than use valuable loan officer time to chase down "delinquent" clients?

Further, flexible contracts may greatly increase the impact of the loan. Clients with rigid contracts may take actions which reduce the return on their investments. Owners of milk animals may underfeed during difficult times. Asset owners may sell off (productive) assets to repay debts. Freedom from Hunger, through its MAHP program, is helping the MFIs CARD, CRECER, and Bandhan to offer emergency health loans to their clients. It would be useful to evaluate this type of product to determine whether it is able to prevent the destruction of this value. Potentially, such a product could be as useful as the initial loan itself. Or if clients can't handle the additional debt burden, it could have negative spillovers, destabilizing their borrowing groups. If the impact is positive, however, the increased income from retaining productive assets could allow the MFI to further increase loan size.

## Conclusion

Rigorous evaluations will become only more important as new technologies are developed to improve the efficiency and scale of microbanking. These same technologies, such as handheld computers for loan officers, have the potential to greatly increase the flexibility offered to clients—by making on-the-spot credit decisions, or handling variable repayment amounts, for example. We have focused here on one issue in particular: the flexibility or rigidity of debt products; but with the deployment of any new technology we are faced with the same unknown: how well does it work? The goal of our research around the world, as with the Innovations for Poverty Action, the Financial Access Initiative, and the Massachusetts Institute of Technology Abdul Latif Jameel Poverty Action Lab, is to bring about consensus about the circumstances under which different products and features and services are optimal for clients and institutions. Related work will shed more light on other important aspects of flexibility, including loan tenure, loan size, group size, and guarantee requirements.

## More Info

Article:

- Field, Erica, and Rohini Pande. "Repayment frequency and default in micro-finance: Evidence from India." *Journal of the European Economic Association* 6:2–3 (April–May 2008): 501–509. Online at: ksghome.harvard.edu/~rpande/papers/repayfreqjeea_1107.pdf

Reports:

- Daley-Harris, Sam. "State of the Microcredit Summit Campaign report 2009." Washington, DC: Microcredit Summit Campaign, 2009. Online at: www.microcreditsummit.org/uploads/socrs/SOCR2009_English.pdf
- Giné, Xavier, and Dean S. Karlan. "Group versus individual liability: Long term evidence from Philippine microcredit lending groups." Working paper. May 2009. Online at: karlan.yale.edu/p/GroupversusIndividual-May2009.pdf

Websites:

- Innovations for Poverty Action (IPA): poverty-action.org
- Financial Access Initiative (FAI): financialaccess.org
- Abdul Latif Jameel Poverty Action Lab: www.povertyactionlab.com

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- The Financial Crisis and the World's Poor
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