

DRAFT VERSION

**Addressing the risks of client over-indebtedness in microfinance**  
**Key issues for MFI management, due diligence and dialogue among stakeholders**

In some countries, over-indebtedness of microfinance borrowers is a growing concern. Recent experience and the current state of the international debate show that this is a critical issue not just since the global financial crisis but has also been a symptom of structural deficits of financial sectors in a number of countries. Major problems have been unchecked growth of Microfinance Institutions (MFI) and, in some cases, unhealthy competition, especially triggered by banks targeting the traditional microfinance clientele with consumer credits and inappropriate lending practices.

Possible consequences are increased cross-indebtedness of microfinance clients. This, in turn, has proved to be one of the main factors of over-indebtedness, which has led to increased (and sometimes persistent) credit risks for microfinance institutions. Ultimately, this could damage the reputation of promoting microfinance as a sound undertaking from both a financial and developmental point of view. **A central challenge is that over-indebtedness does not become visible at an early stage, and it has proved difficult, even now as PAR figures continue to rise, to provide a clearer picture about its magnitude and riskiness.** This is particularly true when an effective credit bureau is missing.

In order to address this challenge, the following is a non-exhausting list of issues for discussion among funders/owners and financial institutions they support. It reflects KfW's recent experiences and includes possible "early warning indicators". It can be used by financial institutions as well as by donors/investors as part of their due diligence exercises. This list should also serve as a framework for knowledge-sharing about a hardly "tangible" but potentially very harmful phenomenon that deserves utmost attention from investors, practitioners and researchers.

**1. Strengthen stakeholders at macro level<sup>1</sup>, particularly, improve the effectiveness of credit bureaus.** Credit bureaus play a crucial role to enhance transparency in the bank-client relationship that is needed to ensure sound credit decisions and avoid client over-indebtedness. Where credit bureaus not yet exist, discuss the regulatory framework in existing institutional settings (role of Ministries of Finance, Central Bank, Superintendecies etc.) and initiate a dialogue with regard to the need for and possibility of setting up credit bureaus. It is useful to have an early clarification of the institutional setting (government vs. non-government approach). Another issue is whether the credit bureau is/will be credible enough to both enforce participation and ensure data protection. Where credit bureaus already exist, questions to be asked include:

- Is the reporting of client data adequately monitored?
- Are the data trustworthy and consistent

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<sup>1</sup> While there are many crucial issues at macro level linked to client over-indebtedness, further work needed to have a good overview on these links. Therefore, this paper concentrates on credit bureaus which have a more direct impact on measuring and mitigating over-indebtedness. Nevertheless, stakeholders and/or funders at macro level should nevertheless be sensitized on the importance to address client over-indebtedness as a cross-cutting task in regulation and supervision.

- Are the data up-to-date? In some countries, credit bureau information is lagging behind several weeks, and clients know this and apply simultaneously for several loans with different institutions;
- What kind of loans do Financial institutions have to report to the clients ((non) regulated, Microloans, credit card loans etc.)?
- What role does the superintendency play?

à Possible indicators on the effectiveness of a credit bureau:

- Number of financial institutions with delays in data transmission;
- Number of client data records;
- Number of reported multiple loans;
- Time lag of data collection and reporting of credit bureaus;
- Regulatory Framework addressing over-indebtedness issues specifically.

**2. Be more cautious with estimating the relevant demand in the financial sector.**

Overestimating demand for financial services in a particular country/region can be a critical factor in supporting (future) client over-indebtedness. Sector/Market surveys are crucial both for investors as part of their due diligence as well as for financial institutions with regards to their expansion scenarios. Questions to be asked include:

- How high is the potential effective demand (bankable clients for credit products) in that country/region?
- How much of this demand is not already met by existing financial institutions and/or by different instruments (e.g. credit cards)?
- Is access to finance really the relevant problem for a sufficiently large group of potential clients in a relevant setting (such as the capital city of the country)?
- Does the business plan / the growth strategy explicitly reflect sound demand estimates?

à Possible indicators

- Number of bankable clients;
- Regional distribution of bankable clients.

**3. Analyse carefully the competitive situation and the behaviour of competitors (market analysis/observation). Competition remains a vital prerequisite for sound financial systems development**

and should therefore not be distorted or even questioned in principal. However, in some cases, the market density and competition levels of urban MFIs in particular have developed in a way that may hamper the development of a sustainable microfinance sector. This has led to a chase even for less creditworthy clients, resulting in an “unhealthy” increase of the loan portfolio (both in terms of number and volume), undermining the repayment capacity of microfinance clients. In this context, questions include:

- How many MFIs operate in the country or in the capital/the respective region?
- Where are they located (branch offices)?
- What credit portfolio growth rates did MFIs experience? Were there any signs of unchecked, disproportional growth (e.g., beyond 40-50 % p.a. for a mature MFI)?
- Does the clustering of branch offices in a particularly area carry the risk that clients are being “wooded away” by competitors?

- Does the marketing strategy reveal aggressive behaviour towards competitors?
- Where credit bureaus do not (yet) exist, check whether the exchange of client data with other competing FI is an appropriate option<sup>2</sup>.

à Possible indicators:

- Number of relevant (M)FIs in the country;
- Market shares of the five biggest relevant (M)FIs;
- Number of different branch offices at "strategic locations" (e.g. the market square);
- Homogeneity of credit products among competitors;
- Major differences in competitors' lending conditions (e.g. "race to the bottom"?).
- Number of multiple-loans-clients ("cross-indebtedness"; at least rough estimates).

**4. Take a critical look on the loan selection and approval process.** At MFI level, this is one of the most critical issues of addressing over-indebtedness issues. Internal control mechanisms (e.g. to get a "quick-and-dirty" evidence, take a random sample of individual borrower files) should address a number of issues sensitive to over-indebtedness factors, including:

- Was a shorter/less stringent loan approval performed because the client was able to give proof of a client relationship to a (certain) MFI, and if so, was this client offered more favourable terms and conditions?
- Was the repayment capacity analysis reduced given that guarantees from third parties had been presented to the loan officer? Were there any checks of the relationship of the guarantors and the borrower (à sometimes, guarantors get paid by borrowers) and the "quality" (e.g. payment capacities) of the guarantor?
- Were there any unusually low average loan balances (hinting at aggressive market strategies (many tiny loans at reduced screening efforts, without field visits)?
- What are the discretionary levels of loan officers to make loan decisions, and how do these levels relate to other institutions in the country?
- Was there any evidence of loans being granted to clients that would otherwise have defaulted or were likely to default?
- Have there been produced any recent household analyses? What were the main results?

Further issues include:

- Check the incentive system for loan officers. Were staff incentives linked to portfolio growth only or also to other indicators, such as portfolio quality?
- Check the effects of an introduction of credit limits (number and volume) by an MFI;
- How does the MFI define over-indebtedness? Assets < payment obligations or current cash income < payment obligations (preferable)?
- Comprehensive staff training and sensibilisation on client over-indebtedness;
- Take a close look at the hiring policy (i.a., dealing responsibly with clients as one of the hiring criteria and as a regular topic of internal training);
- What is the percentage of new loan officers? Have the training measures been adapted to client over-indebtedness issues?

<sup>2</sup> This will certainly only be possible on a voluntary basis and in compliance with statutory regulations (data protection and others). Initial experience of exchange of data among competing MFIs revealed considerable cross-indebtedness and thus first indications of beginning over-indebtedness.

à Possible indicators:

- Existence of a reasonably detailed credit approval manual;
- Share of visits to client locations as part of loan analysis;
- Duration of loan analysis (days from loan application to disbursement, comparison with major competitors);
- Existence of incomplete borrower files.

**5. Detailed analysis of the loan portfolio with regard to over-indebtedness factors.**

Signs of cross-indebtedness can be found in the existing loan portfolio as well, including

- Loans extended to multiple family members who asked for loans in order to overcome loan size limits;
- Loan volumes asked for by applicants have been cut down for risk management reasons (which prompted those clients to seek additional loans elsewhere);
- There is a strong correlation between clients with multiple loans and clients in arrears.

à Possible indicators:

- Share of "pure" consumer loans (e.g. TV sets, etc) in portfolio;
- Share of "open" foreign currency loans in the portfolio (i.e. borrower generates cash flow in local currency);
- Evolution of the PAR > 1 day in the last three months;
- Percentage of restructured loans and/or write-offs;
- Clients with one, two or more loans with other MFIs according their repayment status (current, in arrears, in default), provided that information from a credit bureau is available.

**6. Discuss the institutions' response strategy to (perceived) over-indebtedness.**

This is a topic both for due diligence and board meetings<sup>3</sup>. MFIs should address client over-indebtedness issues in their strategic planning and/or risk management mechanisms, in order to mitigate negative impact of client over-indebtedness on their portfolio quality.

Possible response scenarios include:

- Clear focus on micro-enterprise clients;
- Limit growth and ensure growth strategies balanced with quality and risk management on the one hand and human resource capacities on the other;
- Introduce limits on the number and/or volume of loans of individual clients;
- move to other client segments, for example
  - a. diversify product range from pure Microfinance loan to SME finance products;
  - b. Focus on MSMEs and restrictive approval of consumer loans.
- consider attracting more clients outside urban centres which less competition, by
  - starting to offer rural/agricultural loans;
  - reviewing the current branch network expansion strategy<sup>4</sup>;
  - Start/enhance the use of branchless banking instruments.
- Specific staff training focused on over-indebtedness issues, review incentive schemes.

<sup>3</sup> MFI client over-indebtedness plays an important role in risk analysis of funds/holdings.

<sup>4</sup> It is, of course, problematic to recommend to a financial institution that it should "stay away" of existing locations of competitors, particularly when the location is generally attractive (central market and similar locations). On the other hand, the branch office policy should be strictly guided by the realistic potential of attracting relevant clients. The main criteria should be a meticulous market analysis for each branch office as well as the conscientious review of all loan applications.