THE CLIENT PROTECTION PATHWAY

PREVENTING OVER-INDEBTEDNESS

IMPLEMENTATION SERIES 2

Cerise + SPTF

Our Goals

Defining over-indebtedness

Understanding over indebtedness (what, why, when)

Preventing over-indebtedness - a systems approach *(repayment capacity analysis emphasis)*

Compliance with Entry Level Minimum Requirements

Is there a risk of over-indebtedness in your market?

1. There are many – or an increasing number of – informal sources of finance available
2. There are many – or an increasing number of – lending institutions
3. Consumer lenders are moving into the same market as microfinance
4. Multiple institutions often compete to serve the same customers
5. Credit bureaus are not available, are inadequate, or not widely used
6. Clients complain about not having the right product fit, including the price and/or the size
7. FIs experience high turnover and/or difficulty providing adequate training to staff
8. FI incentives place a high value on portfolio growth

What is Over-indebtedness?

1. Net indebtedness approach

A [household or] person is considered over-indebted when they are unable to repay a loan, that is to say income, after deduction of living expenses, is no longer sufficient to meet the repayment of debts [for a long time period] as they fall due.

2. Sacrifice approach

If a family has to make sacrifices that significantly affect their quality of life, or if a microbusiness has to make sacrifices that reduce its income generating capability, that is debt stress."

3. Default/delinquency approach

A microfinance client is over-indebted if he/she has on-going difficulties in paying back the loan.

3 APPROACHES

Remember!

- Many definitions of over-indebtedness but all have certain core features in common:
  - Clients face large amounts of debt (relative to income)
  - Debt strains personal, professional, and social components of client's’ lives

- Over-indebtedness should not only be a concern in some over-heated markets, but it can also happen any time with any client

→ Over-indebtedness should be identified, measured, and prevented

WHEN CAN OVER-INDEBTEDNESS HAPPEN ? E.G. FROM GHANA

Analysis of sacrifices of micro-borrowers by prevalence, acceptability and frequency (Ghana)

- Jessica Schicks, Centre for European Research in Microfinance (2012)

One study of overindebtedness in Ghana[89] highlights the seriousness of client repayment difficulties. The study examined debt stress in over 500 Ghanaian microfinance borrowers. The data below demonstrate how many times the borrowers in the study sample reported each of the common "sacrifices"—things that the borrower gave up in order to make a loan repayment. The list emphasizes how indicators like debt service rations, default, and delinquency often do not reflect the true state of client overindebtedness.

Number (%) of borrowers making each sacrifice	Sacrifices
325 (61%)	Work more than usual
240 (54%)	Postpone important expenses
179 (34%)	Deplete savings
96 (18%)	Reduce food quantity/quality
67 (13%)	Use family/friends' support
51 (10%)	Suffer psychological stress
26 (5%)	Reduce education
20 (4%)	Borrow anew to repay
20 (4%)	Sell or pawn assets
15 (3%)	Feel threatened/harassed
14 (3%)	Suffer from shame or insults
4 (1%)	Seizure of assets

- So FSP repayment is good and PaR is low
- But all is not good at client level

Loan default

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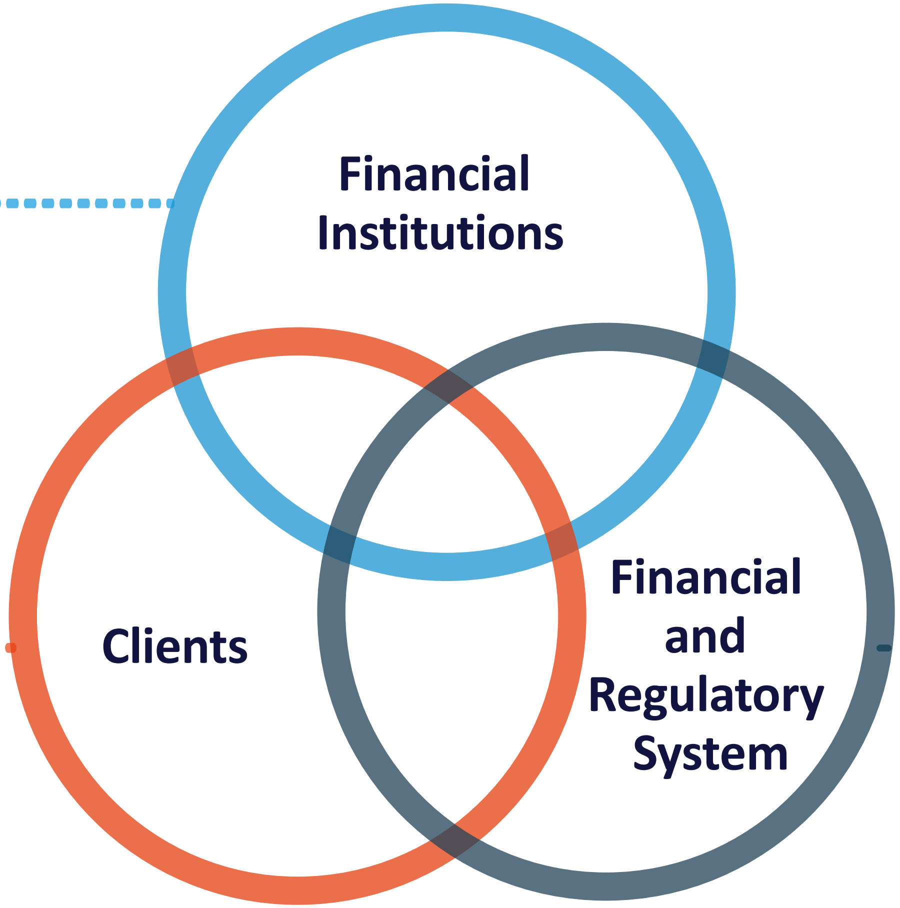
Over-indebtedness

Why does over-indebtedness happen? (I/II)

Policies and processes related especially to repayment capacity assessments and delinquency management



Create policies that will impact FIs and clients – e.g., interest rate caps, mandatory restructuring of loans

Influenced by socio-economic conditions related to their own actions and those of others like FIs, business stakeholders

Why does over-indebtedness happen? (II/II)

Clients

- **Financial decisions**: Clients make poor decisions
- **Unexpected events/shocks**: Clients are impacted by personal life events beyond their control
- **Poverty**: Clients are forced to take loans they know they cannot afford to cover basic life necessities

Financial Institutions

- **Non-transparency:** Loan conditions are not communicated/made clear
- **Poor Loan Officer Incentives:** Loan officers are encouraged to grow portfolio aggressively
- **Poor Repayment Capacity Analysis:** Institution does not know how to properly review client's creditworthiness
- **Poorly designed repayment schedule:** Clients are forced to pay in times when they have no money.

Regulators

- **Macroeconomic Shocks**: Changes in the economic condition has impact on prices or value of credit.
- **Poor Regulation**: Regulation incentivizes bad behavior or, at best, does not properly discourage bad behavior by participants.
- **Poor intra-industry coordination**: Financial institutions have no mechanism for learning about clients (e.g., no credit bureau)

Preventing over-indebtedness

Over-indebtedness is a client protection problem most likely to cause significant harm, both to individual clients and to providers.

Borrowers should be able to handle debt service requirements without sacrificing their basic quality of life.

The entire credit process should be designed with this in mind; and other internal systems (HR, IT, audit, etc.) should provide further reinforcement.

Preventing over-indebtedness – a systems approach

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Product and process design

Design for purpose

Target clientele
Loan purpose
Eligibility criteria for each product

Policies that support design for purpose

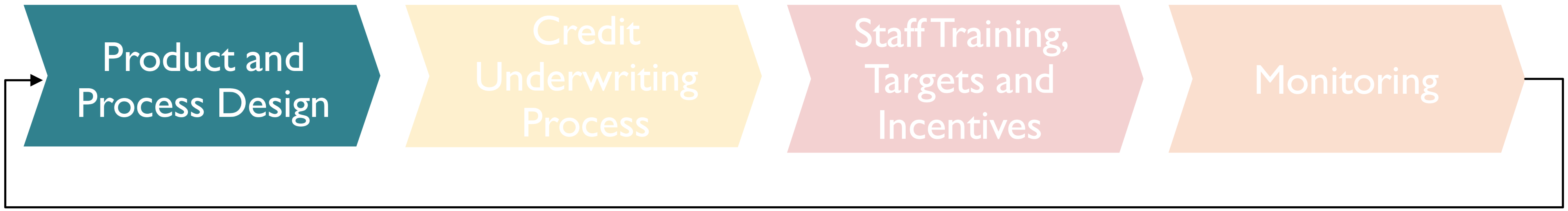
Market research (client segmentation)
Pricing policy
Avoiding aggressive sales practices
Repayment capacity assessment

Fair collateral requirements

Right type and right size collateral
Collateral seizing policy

Monitoring

Satisfaction survey/Client exit/Complaint data



Product and process design

1. The Universal standards for Social Performance Management: Implementation Guide
   - Dimension 3: Page 107
2. Market research guidelines, tools and templates – see www.sptf.info

Preventing over-indebtedness - a systems approach

Credit underwriting: data (I/VI)

Third party checks

What data?	From where/who	Base data points
Applicant background	Available databases: Own data Credit Bureau FI data sharing Other external (payments, utilities)	Arrears Loan rejections Write-offs Refinance/Restructured History of late payments
References	Home and business neighbours Suppliers Guarantors	Applicant stability trustworthiness Willingness to repay Guarantors

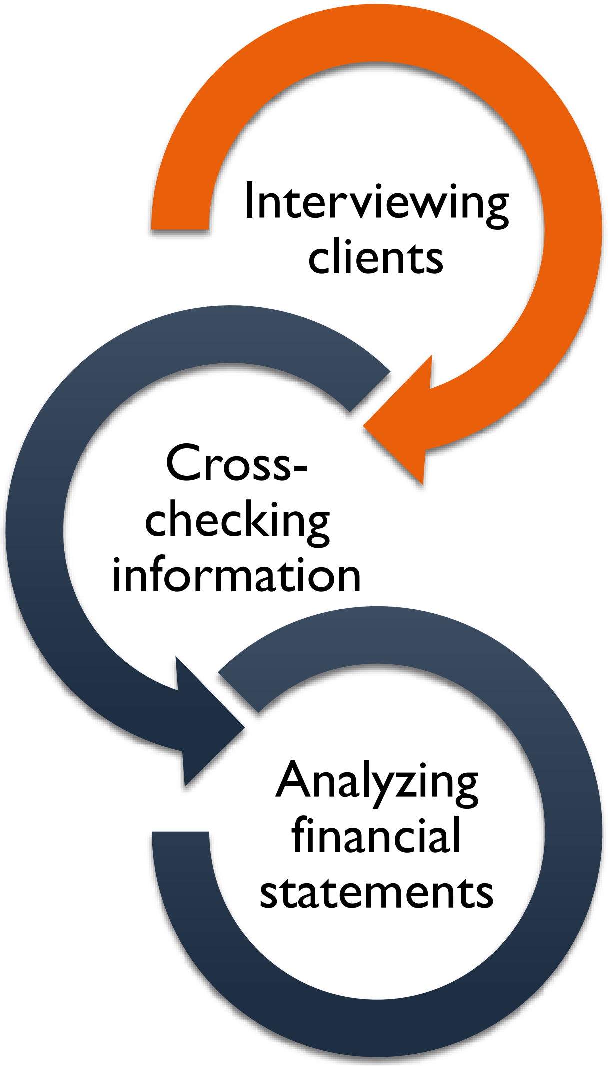
Product and Process Design → Credit Underwriting Process → Staff Training, Targets and Incentives → Monitoring

Credit underwriting: data (II/VI)

From applicant

What data?	Base data points
Non-financial	Applicant's business situation: experience, stability, and orderliness; commitment to the business; and business size and intended loan use Family and personal situation: characteristics of family and household; personal characteristics
Financial	(1) A joint business and household income statement: Sales and cost of sales; operating expenses; other family income; family expenses; family debt repayments (2) a joint business and household balance sheet: Current business assets and liabilities; fixed business assets and long-term business liabilities; and family assets and liabilities (3) cash-flow statement and projections & a business seasonality analysis
Collateral	Collateral evaluation: Description, Location, date of purchase, purchasing value, estimating current value

Credit underwriting: process (III/VI)



Visit the client's business and home

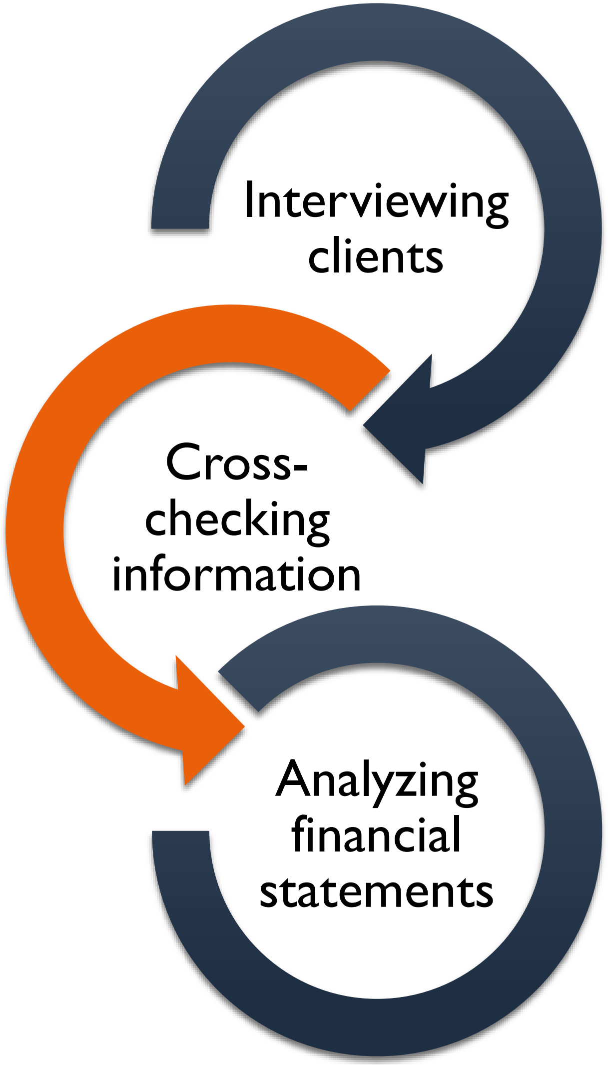
Collect financial information, at a minimum:

- Business income & expenses
- Whole household's expenses
- All other outstanding debt payments

Assess non-financial information:

- Consistency of the loan purpose
- Income perspectives / seasonality of income
- Management capacity
- Consistency between declarations and observation
- Willingness to repay / character
- Family situation

Credit underwriting: process (IV/VI)



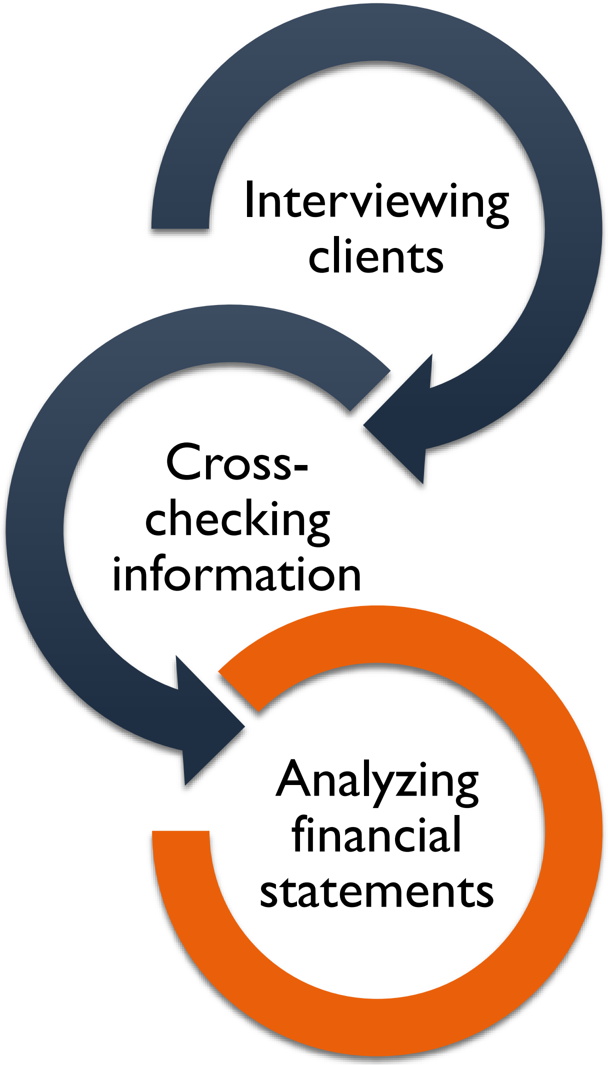
Cross-checking is determining the accuracy of information by checking it through various sources

☞ Use cross-referencing questions to validate declaratory information

Examples:
- How much revenue per week/month // how often does the client need to supply
- How much cash on hand // recent sales and expenses
- How many days of revenue to cover the loan installment?

Build on field staff's experience to validate financial information

Credit underwriting: process (V/VI)



Draw at least a monthly cash flow statement, and possibly a balance sheet

☞ **Net available cash is the basis to determine loan amount and term**

Use rational debt thresholds:

- Have a mixture of ratios that help make an informed decision

Analyze key ratios (*suggestions*):

- Look at consistency of margin within the sector
- Look at business indebtedness relative to total assets or equity
- Look at working capital need relative to loan amount

Credit underwriting: process (VI/VI)

Guiding principles for data evaluation

Observe the following guidelines throughout the entire data evaluation process:

1. Household surplus is the best indicator of the applicant's capacity to repay

2. Collateral and guarantees are a secondary source of payment and confirmation of client commitment to repay, but the lending decision should be made based on repayment capacity.

3. Loan approval limits should be adjusted as needed. During a period of system-wide delinquency, or in an over-saturated/overheated market, institutions should set more conservative standards for loan amounts, and number of outstanding loans from all sources.

4. If credit bureaus are unreliable, outdated, or non-existent, the calculation of the client's repayment capacity should take into consideration the possibility of additional, non-disclosed debt

Approval: loan amount

DEBT CAPACITY

Amount depends on the applicant's debt capacity

CALCULATION

$$\frac{\text{Recommended Loan Amount}}{\text{Working Capital}}$$

Others important factors

- Indebtedness levels
- Liquidity
- Profitability

Small holder farmers/livestock

- Crop and livestock sale, raw material inputs
- Amount of agriculture land
- Profile: buyers, labour employed, contracts in hand, main income source (e.g., 75%/35% agriculture/wage)

WORKING CAPITAL

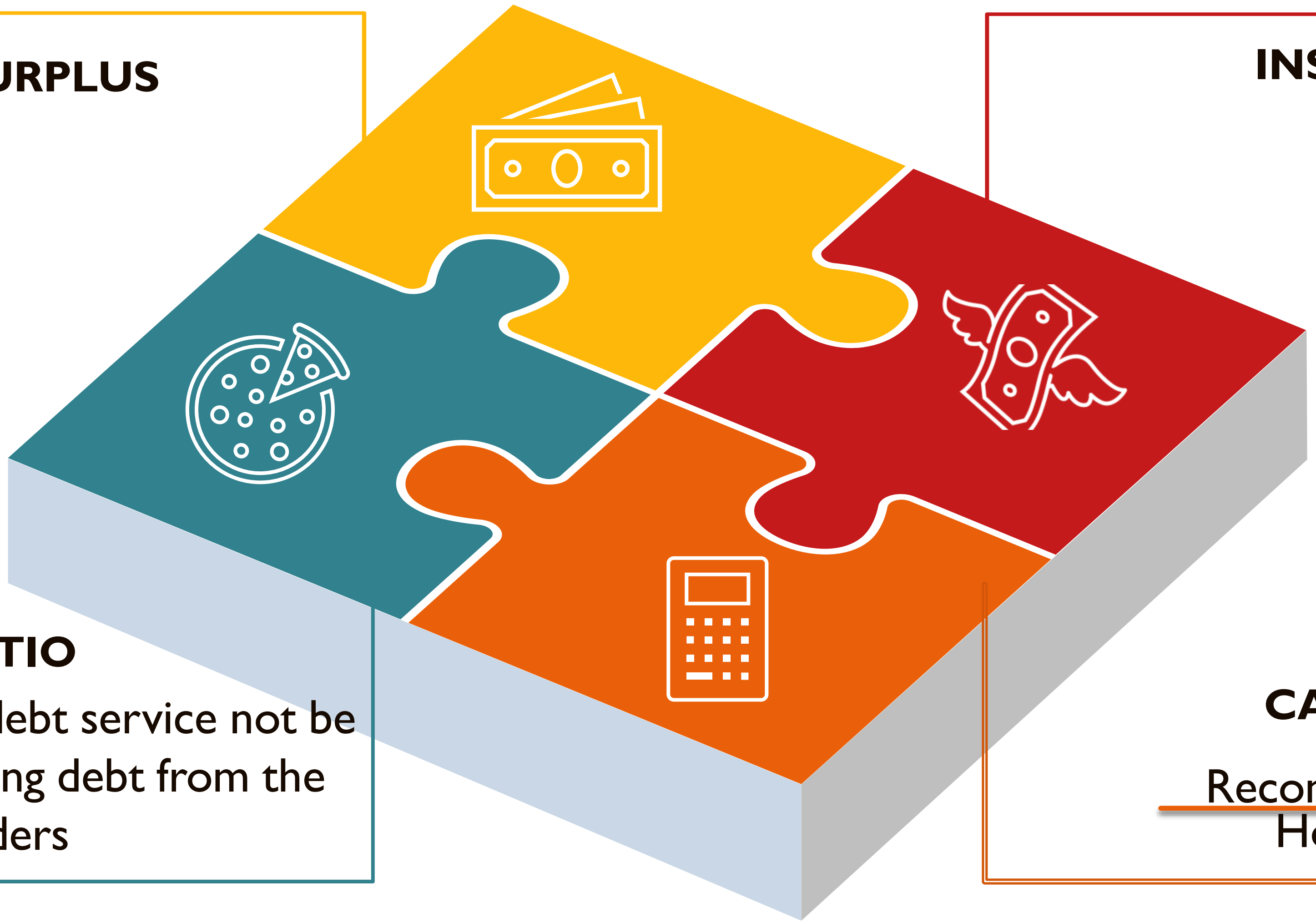
Most important indicator of debt capacity is an applicant's current working capital

BENCHMARK RATIOS

Trade & Manufacturing – 150 %
Services – 200%
(of working capital)

Preventing over-indebtedness – a systems approach

Approval: loan installment



HOUSEHOLD SURPLUS

A measure of the applicant's capacity to repay

INSTALMENT AMOUNT

Should not exceed a proportion of the total monthly HH surplus

BENCHMARK RATIO

Disposable income to debt service not be higher than 70%, including debt from the provider and other lenders

CALCULATION

$$\frac{\text{Recommended Instalment}}{\text{Household Surplus}}$$

Approval: loan term and repayment frequency (III/III)

LOAN TERM

- Lenders normally have pre-defined length of time to repay the debt
- Ideally it should depend on loan amount, repayment capacity, and cash-flow regularity

REPAYMENT FREQUENCY

- Depends on pattern of sales
- Consideration seasonal cash flow (e.g. agri)
- HAS TO FIT THE CASHFLOW

Credit underwriting process: resources

1. The Universal standards for Social Performance Management: Implementation Guide
   - Dimension 4 Standard 4A: Page 134
2. Avoidance of Over-indebtedness: Guidelines for Financial and Non-Financial Evaluation

This is a core resource for individual lending

Preventing over-indebtedness – a systems approach

Staff training, targets, incentives

Staff training

- Client interview techniques & cross-checking information collected
- Financial analysis
- Ensuring client understanding
- Identifying cases of distress

→ Continuous mentoring by Senior LO

Targets

- Targets account for internal and external factors
- Targets don't encourage aggressive sales
- Red flag if high caseload

Incentive

- Values portfolio quality at least as highly as other factors
- Fixed portion must represent at least 50% of total salary
- Reviewed annually considering context

Product and Process Design → Credit Underwriting Process → **Staff Training, Targets and Incentives** → Monitoring

Staff training

Critical for effective repayment capacity assessment

- **Train staff on policy and procedures**
  - Use case study method
  - Ensure there is field training/client visits are included
  - Training should include:
    - Completing RCA's for different products
    - Train the staff on how to do cross checks
    - Using different ratios for loan amount and approval decision making
    - How to use the 'willingness and ability' to pay matrix for clients
  - Use easy to fill and straightforward forms that capture only data that is processed into usable information and calculates ratios automatically.

Monitoring over-indebtedness

The FI monitors the market and responds to heightened over-indebtedness risk

Awareness of the top management unfolds in the whole institution:

- Define OID indicators (e.g., PaR levels, clients/LO) that trigger additional internal monitoring and response
- The infrastructure is organized for regular reporting
- Internal Audit provides feedback on internal controls

At sector level…

Over-indebtedness risk is discussed at the highest level including with other players in the market

Monitoring over-indebtedness: Information sources

First available indicator is the portfolio quality:

- Portfolio quality monitored monthly (quarterly at least by top management)
  - By branch, product, and client segment
  - When reaching a certain level, it triggers additional monitoring and response
- Track restructured, rescheduled, or refinanced loans
- Field staff productivity ratios
  - Investigate those that are above a predetermined threshold

But over-indebted clients don't necessarily appear in PAR.

- Analyze growth rates by branch/region
- Monitor clients who repay early in order to get new loans
- Monitor field staff productivity ratios
- Do an RCA at EACH LOAN CYCLE

Staff Training and Monitoring: resources

1. The Universal standards for Social Performance Management: Implementation Guide
   - Dimension 4 Standard 4A: Page 136 (list of resources)
   - Dimension 4 Standard 4A: Page 137 (monitoring over-indebtedness)
2. Loan Officer Manual Banco Solidario
3. Imp-Act Guidance Note on Staff Incentive

Compliance with CPs – entry level - minimum requirements

There are 7 entry level indicators

- Loan approval decisions are made by at least two people, one of whom does not interact directly with the client.
- The provider conducts a cash flow analysis that considers income, expenses and debt service related to business and family, and any other sources of revenue, including informal sources.
- If a credit bureau exists, the provider reports client data to credit bureaus and uses credit reports in the approval process for loans.
- The provider does not use guarantees, guarantor income, collateral, and/or insurance coverage as proxies for repayment capacity as the main basis for loan approval.
- Management and the board of directors monitor portfolio quality to identify over-indebtedness risk. Minimum frequency: quarterly (management); annually (board)
- The provider defines PAR levels that trigger additional internal monitoring and response.
- If loan officer salaries are comprised of a fixed and a variable portion, the fixed portion must represent at least 50% of total salary and it must constitute a living wage.

SPTF

Promoting standards & practices for responsible inclusive finance

THANK YOU