Preventing and Managing Over-indebtedness

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Objective of the session

- Over-indebtedness is one of the key challenges that may affect clients, as well as FSP and a whole market.

- Drawing upon an understanding of what may be the causes and the consequences of over-indebtedness, participants will get an overview of best practices to reduce the risk of over-indebting clients, and on how to respond.

Agenda

- Is there a definition of over-indebtedness? (5 mn)
- Understanding the causes (10 minutes)
- Main results of Client Voices research (5 minutes)
- Preventing over-indebtedness (30 minutes)
  - Through the entire credit process
  - Focus on the repayment capacity analysis
  - Measuring the risk of over-indebtedness
- Responding to over-indebtedness (20 minutes)
- Questions & answers (15 minutes)

What is over-indebtedness?

The Simple Answer:

Over-indebtedness is when clients have more loans than they can afford

The Complicated Answer:

Is more complicated…

Attempts to define over-indebtedness

- *Sacrifice approach*

"A microfinance customer is over-indebted if he/she is continuously struggling to meet repayment deadlines and structurally has to make unduly high sacrifices related to his/her loan obligations" *("Microfinance Over-Indebtedness: Understanding its drivers and challenging the common myths", Schicks J., 2010)*

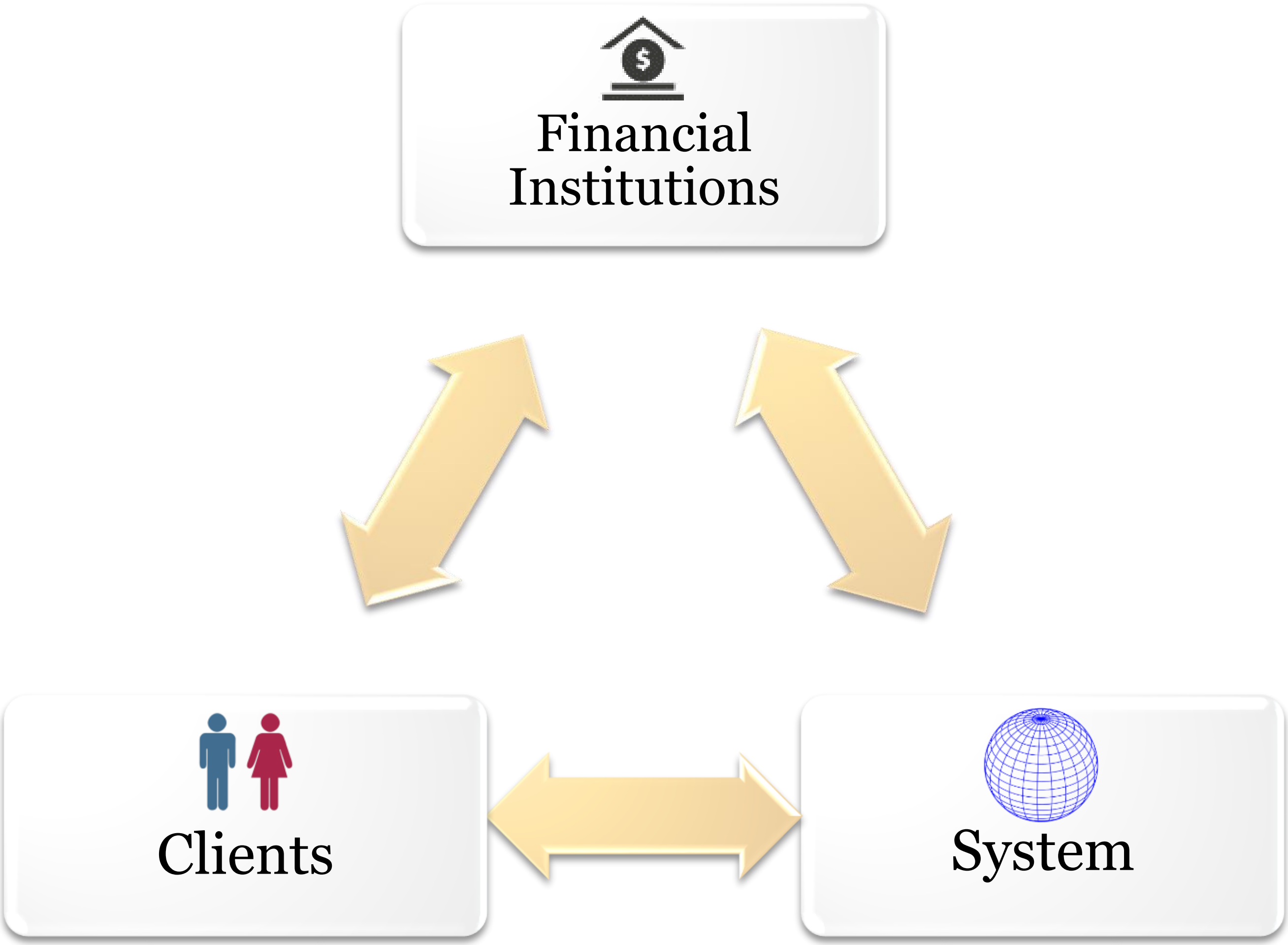
- *Net indebtedness index (NII) approach*

"A microfinance borrower is over-indebted when his/her total debt service is higher than his/her net income during a defined timeframe, whether it is from one or multiple loans" *(Cambodia Over-indebtedness study, 2013. Incofin, Blue Orchard, Oikocredit)*

- *Default/delinquency approach*

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

Why does over-indebtedness happen?



Responsibility lies with the confluence of three actors involved in every microfinance transaction

Why… > The Clients:

- **Financial Imprudence**: 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

Why… > The Financial Institution

- **Non-transparency:** Loan conditions are not 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.
- **Multiple Loans:** Institution does not have standards for number of outstanding loans client allowed to have at once
- **Poorly designed repayment schedule:** Clients are forced to pay in times when they have no money.
- **Greed:** Financial Institutions are uninterested in social mission

Why… > The System

- **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

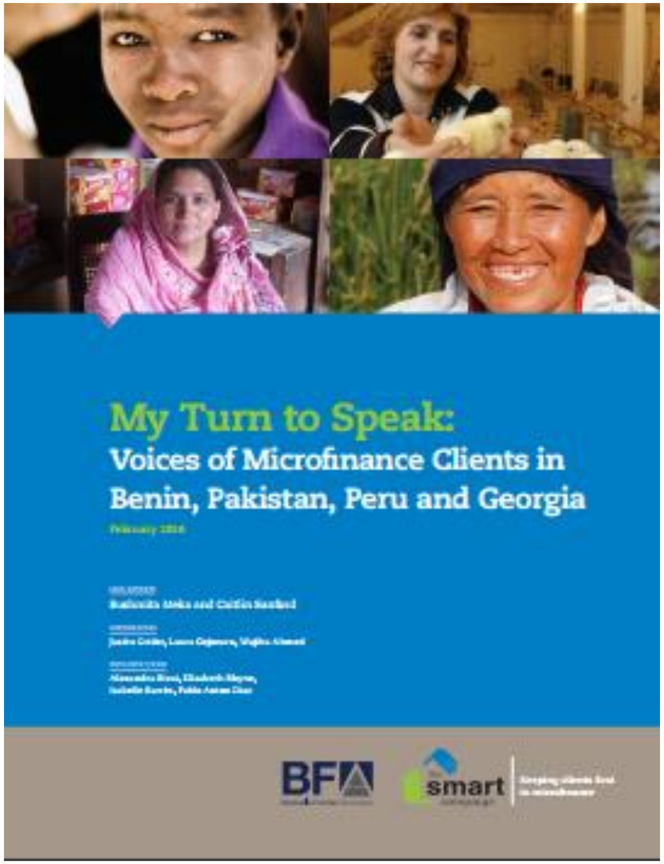
Remember!

- 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, it can happen any time with any client

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

Client perspective

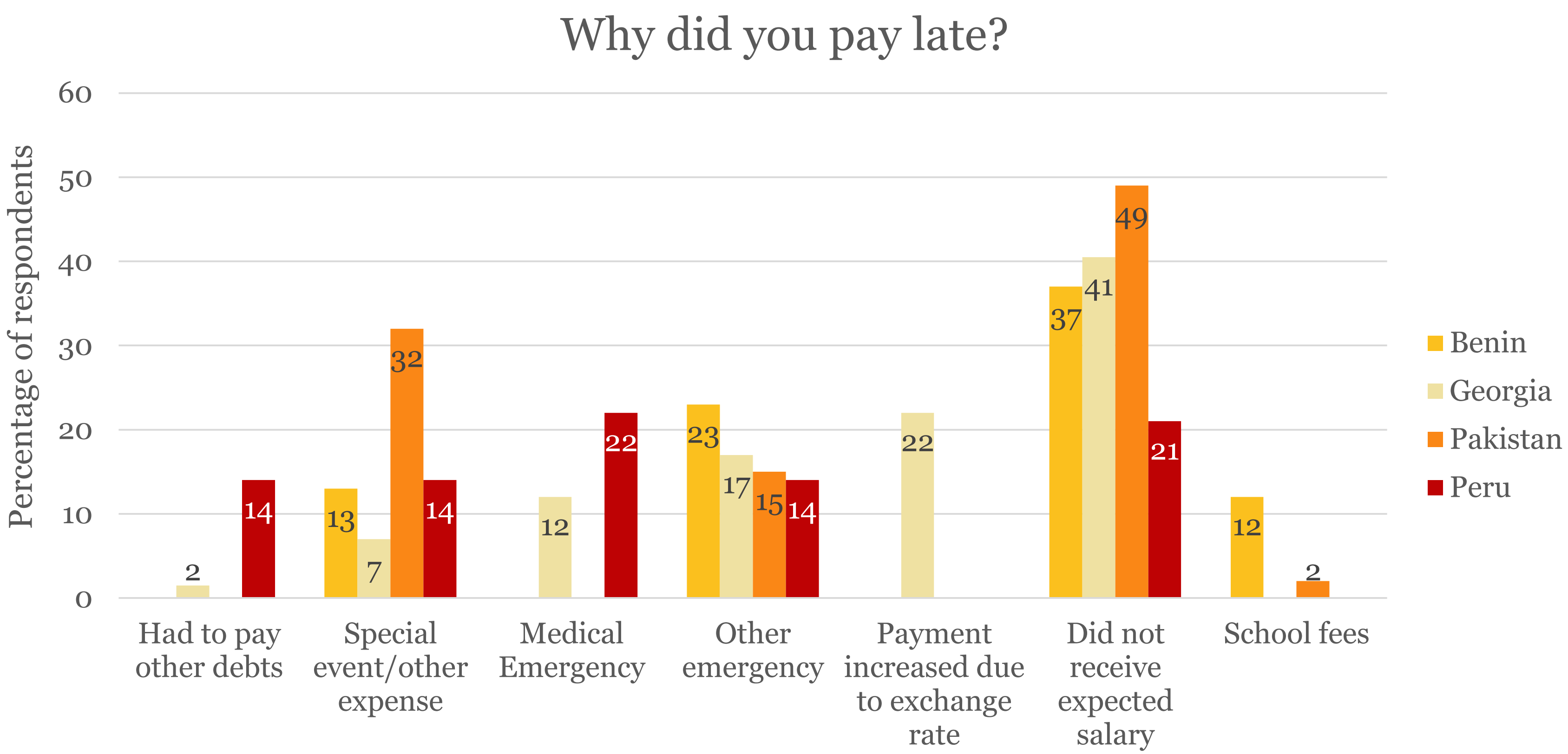


My Turn to Speak aims to understand and shine the light on the experiences, concerns and worries of individuals who use microfinance services.

The research encapsulates **the voices of over 4,500 current and former microfinance clients** in Benin, Georgia, Pakistan and Peru, sharing their experiences with financial providers and their thoughts on what constitutes good and bad treatment.

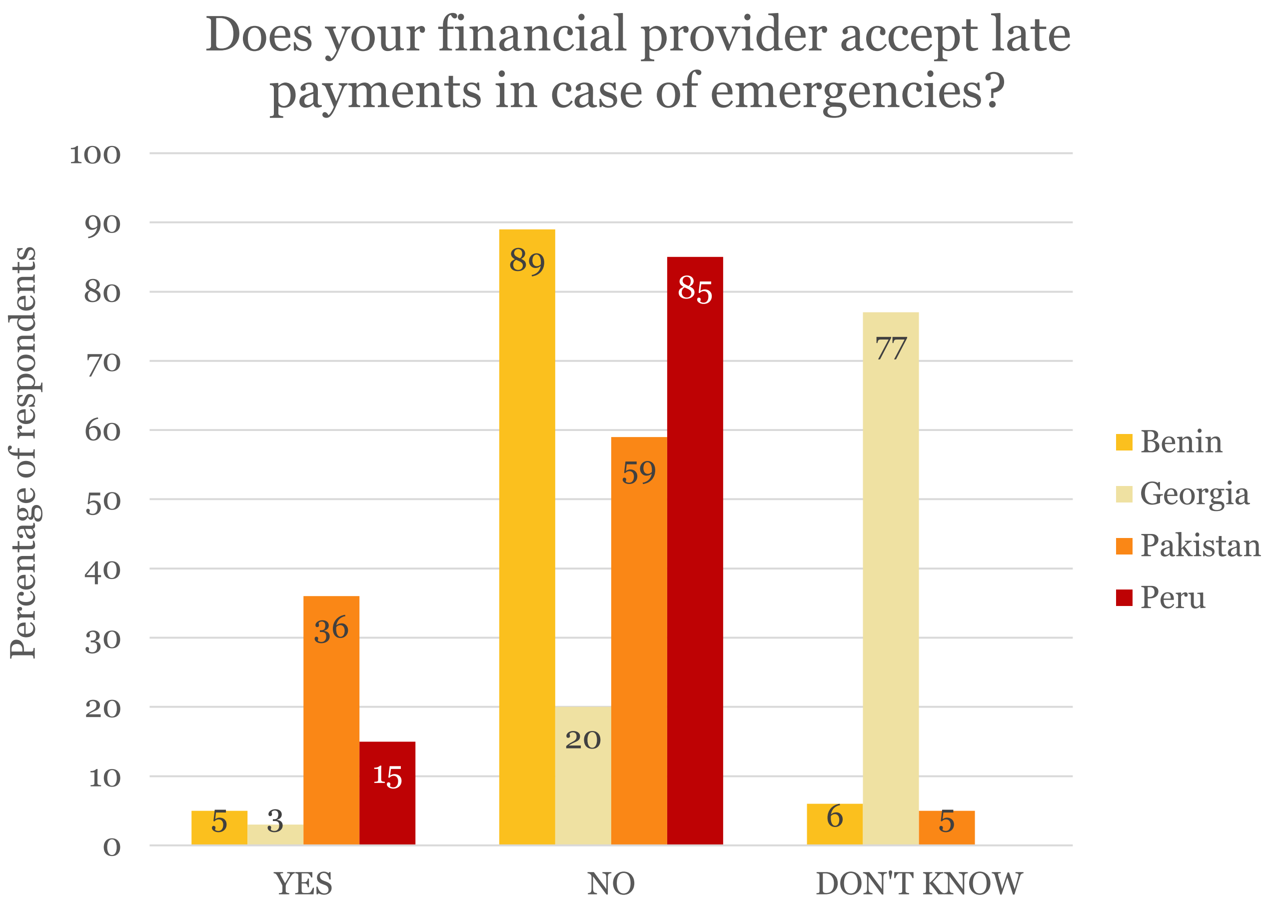
Find the 2016 Synthesis report here: My Turn to Speak

Reasons for late payment



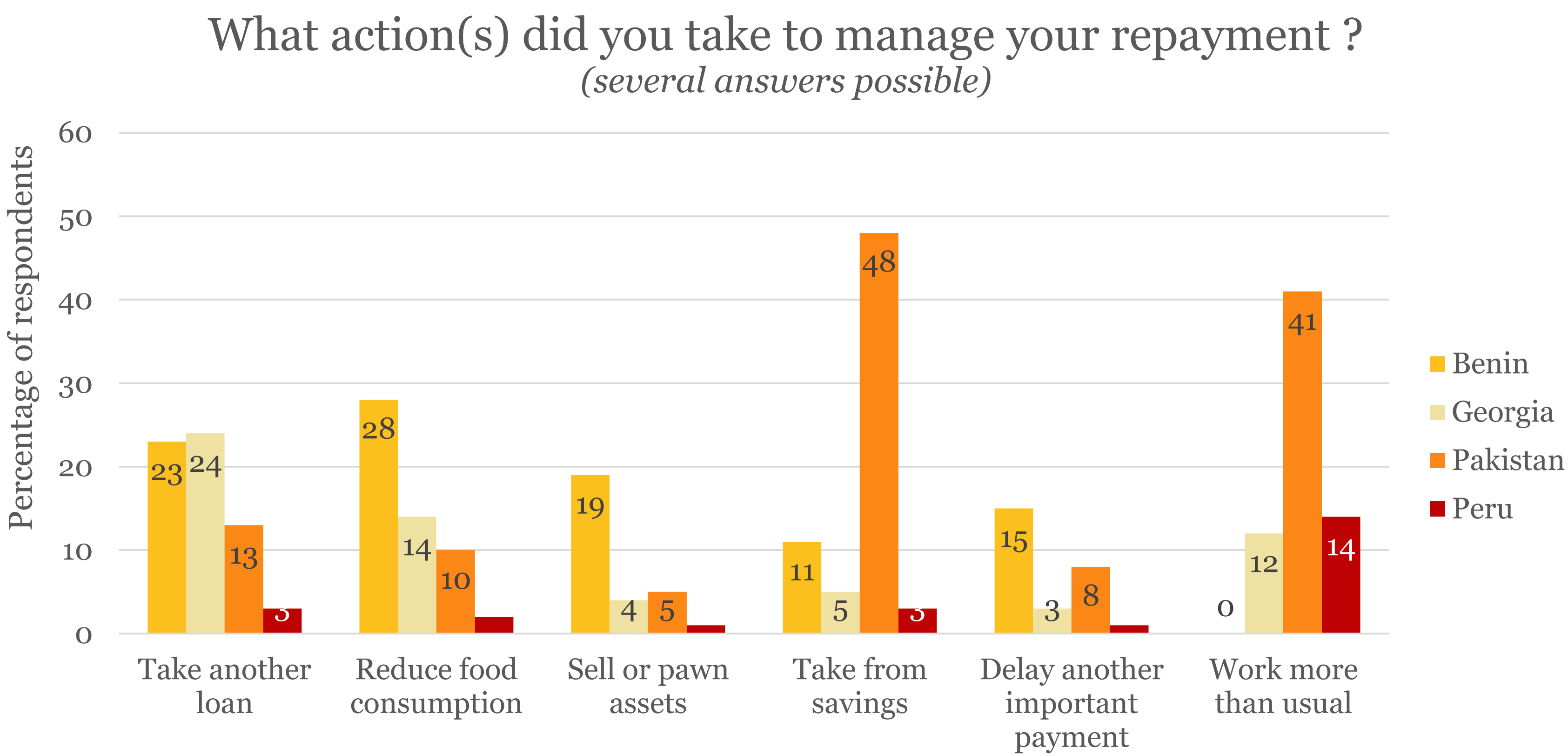
→ Reasons are often out of clients' control

Solutions are scarce



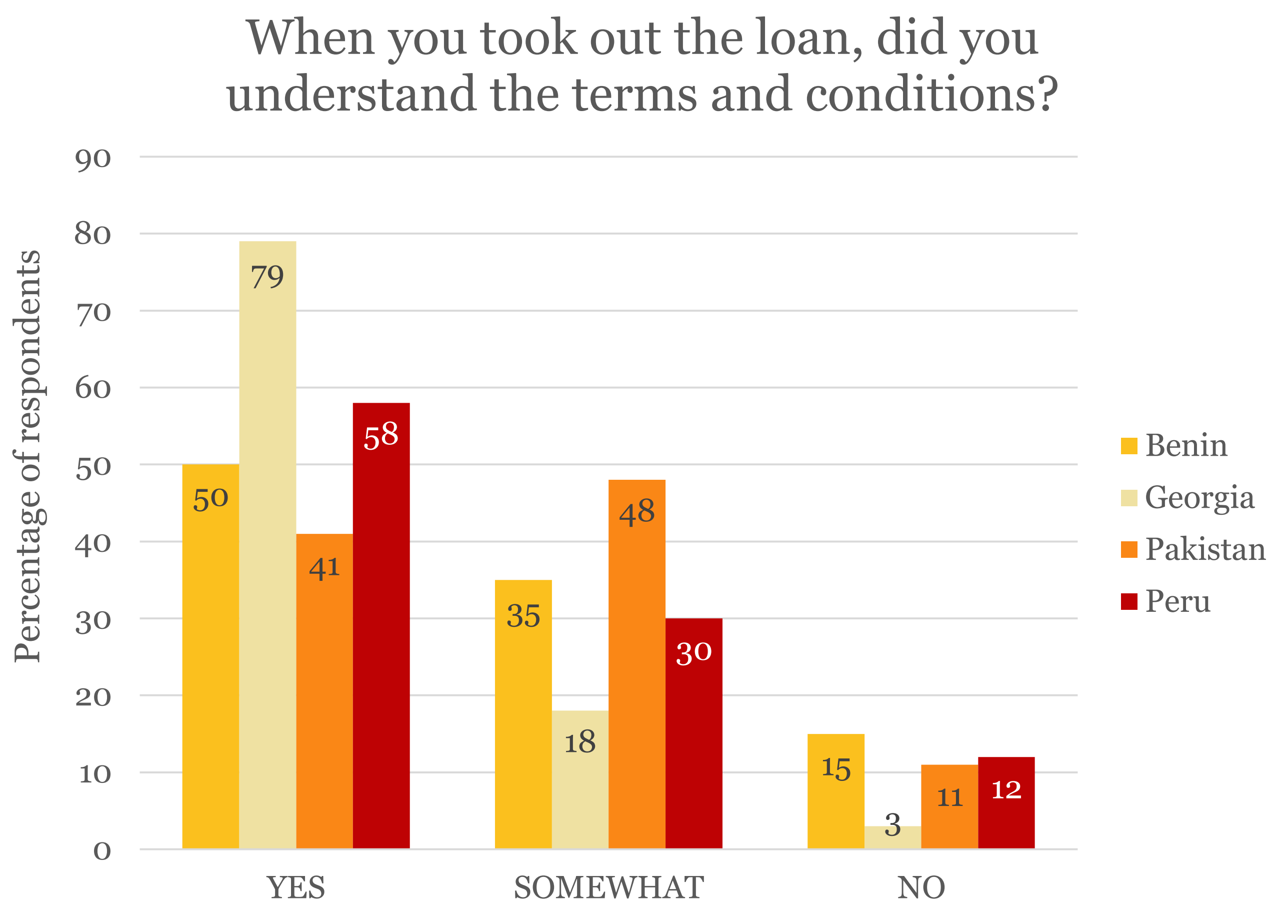
→ Clients universally seek empathetic treatment and flexibility in the case of legitimate emergencies

Some take extreme measures to keep up with repayment



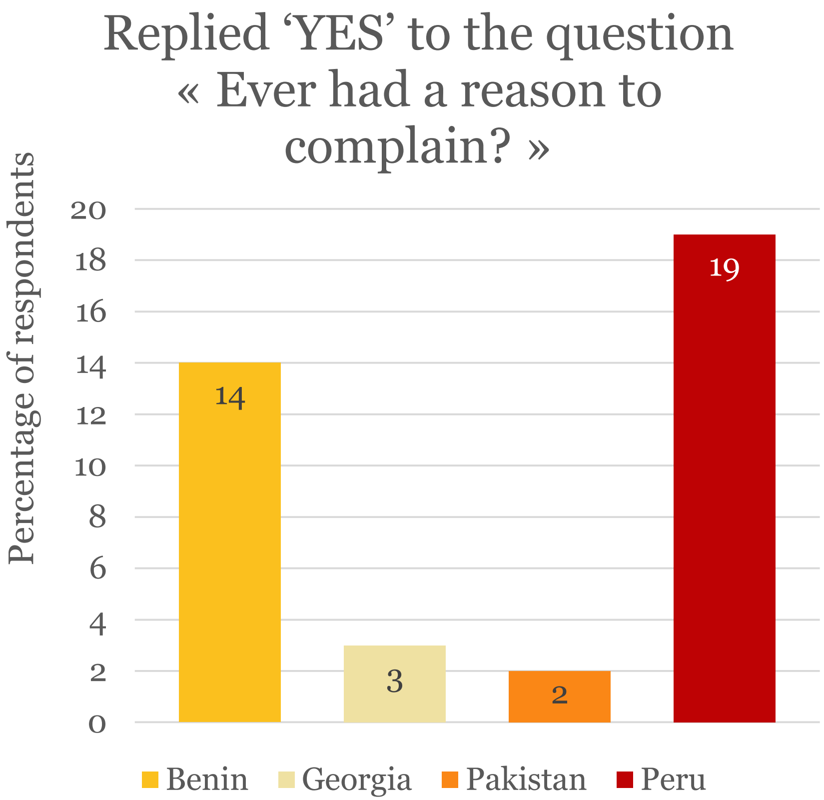
→ Clients report their FSP is unforgiving in case of legitimate emergencies.

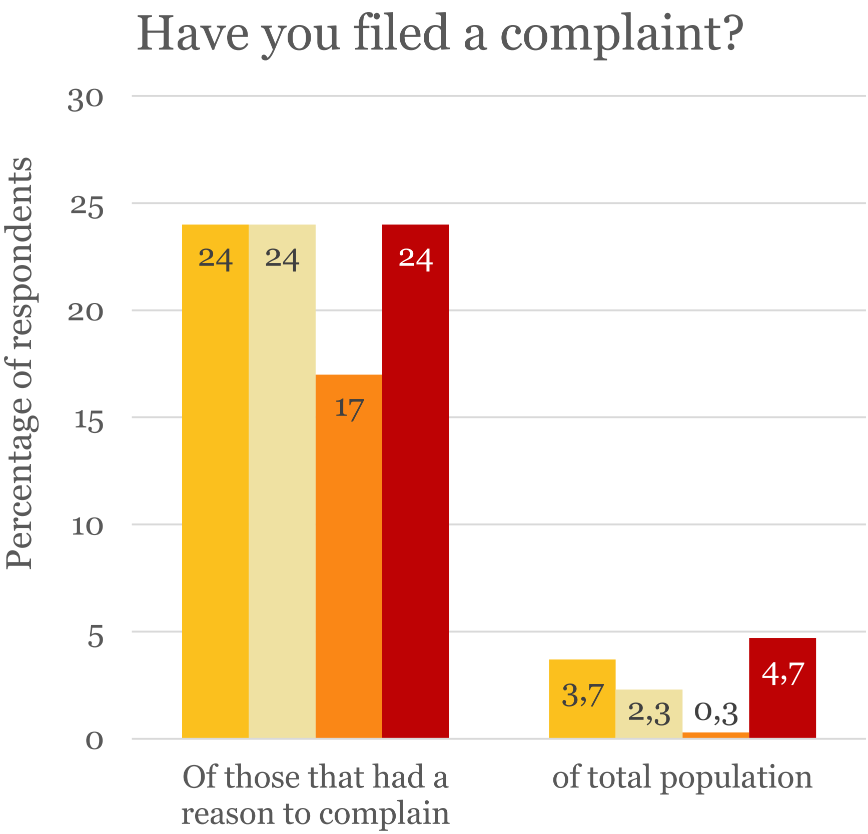
Despite disclosure, clients lack understanding



→ Most clients are surprised by the costs and confused with bundled insurance products

Lack of awareness (or trust?) about recourse mechanisms





→ Clients may not feel empowered to speak up

Preventing over-indebtedness

- Over-lending is perhaps the 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.

So what *can* a provider do about it?

- Products are designed to be suitable to clients and do no harm
- Staff are encouraged and trained to disburse loans that clients *can* repay
- The loan approval process uses appropriate information and criteria
- Senior management measures, monitors and responds

1. Product design & monitoring

- Corporate strategy is reflected in product design

Sets the basis to define:
- Target clientele for each product
- Loan purpose
- Eligibility criteria for each product
- Capacity of the provider to absorb potential losses

- Policies support a rational product design

Product design is based on:
- Market studies
- Rational pricing policy
- Affordability assessment
- Clients' cash flow

- Fair collateral requirements

- No pledge on livelihood items or items needed to generate basic income
- Fair collateral valuation

- Monitoring the suitability of products

Products and services are improved from:
- Satisfaction surveys
- Drop-out analysis
- Complaints

2. Staff disburse quality loans

- Targets are achievable & sustainable

Not too high, not too low
Targets don't encourage aggressive sales
Red flag if high caseload

- Incentive system

Values portfolio quality at least as highly as other factors
No more than 50% of total salary
Reviewed annually considering context

- Loan officer's training

Induction and refresher training in:
- Sales
- Client interview techniques & cross-checking information collected
- Financial analysis
- Ensuring client understanding
- Identifying cases of distress

→ Continuous mentoring by Senior LOs

3. Client under-writing process

- Credit history check

Policies define non-eligibility criteria
If no credit bureau, efforts are made to share data with competitors, as possible

- Debt thresholds

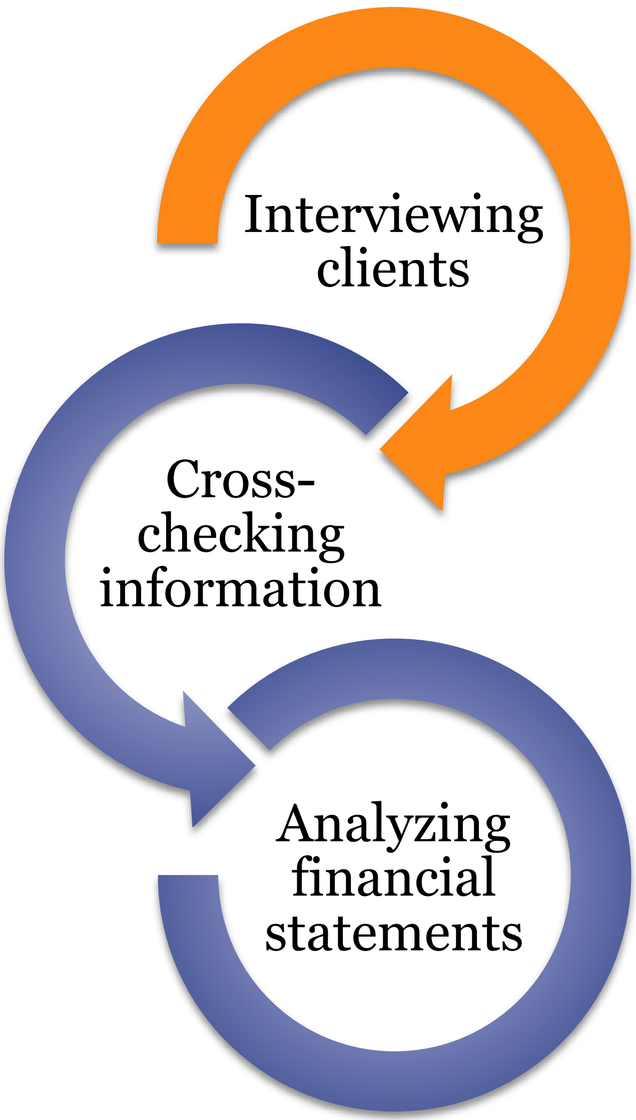
Policies define at least:
- Maximum number of loans/outstanding debt incl. from other sources
- Maximum % of disposable net income applied to debt service

- Repayment Capacity Analysis

- Loan approval

- Involves at least another person than the loan officer that has the client relationship
- Doesn't rely mainly on the guarantee or the insurance coverage

FOCUS: repayment capacity analysis



Visit the client's business and home

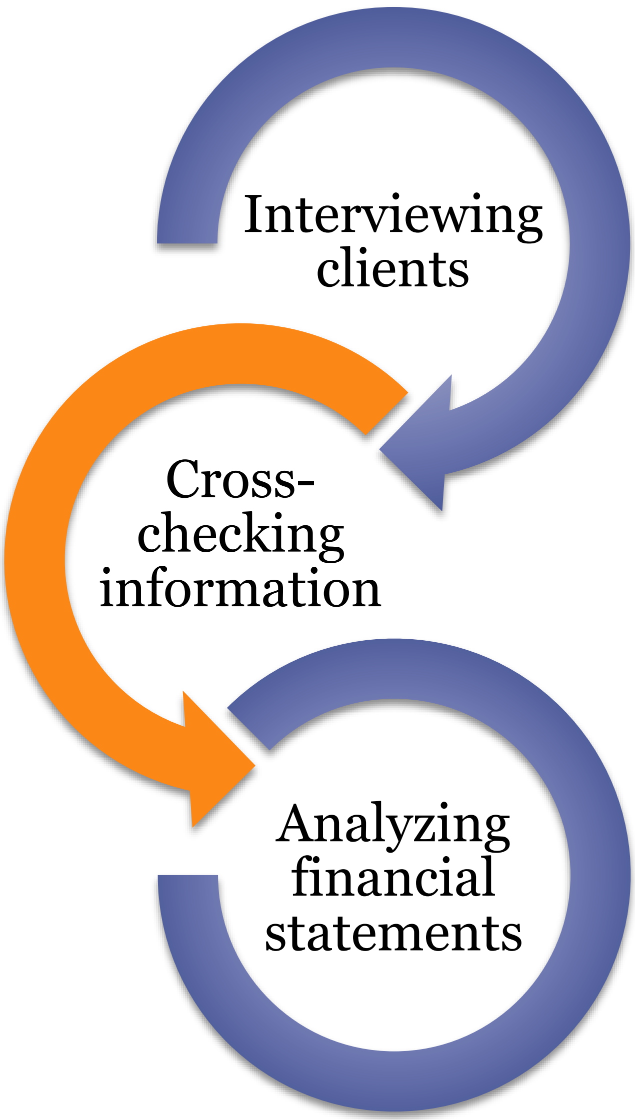
Collect financial information, at a minimum:

- 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

FOCUS: repayment capacity analysis



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

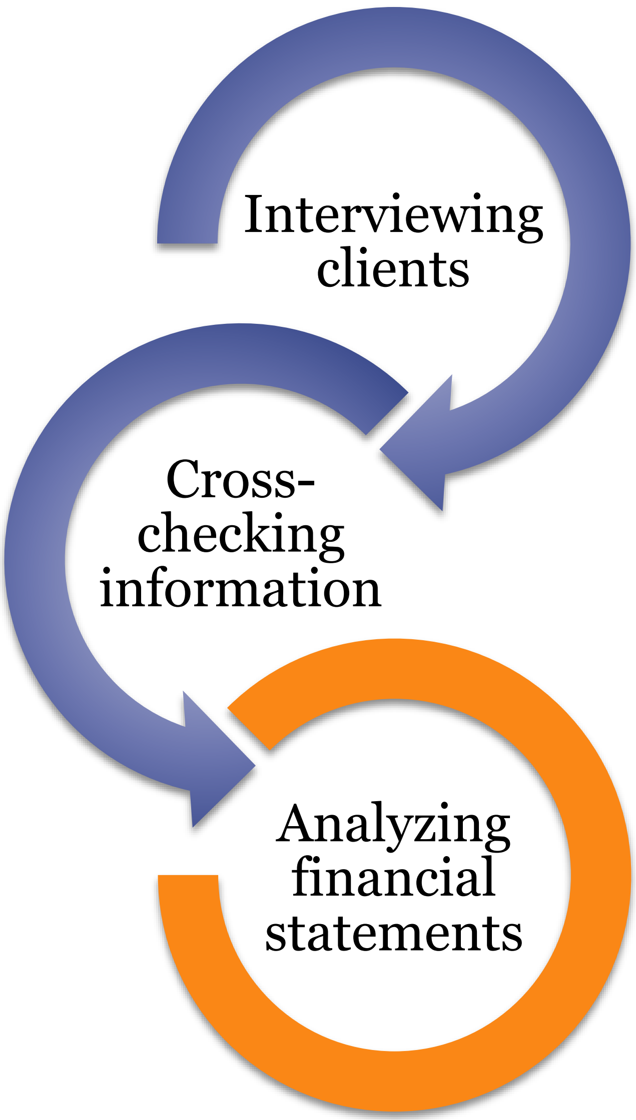
→ Use cross-referencing questions to validate declaratory information

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

FOCUS: repayment capacity analysis



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

Suggestions for a sound repayment capacity analysis

- Train loan officers on interview techniques
- Define and analyze thresholds
- Have a standardized, clear and complete form*
- Challenge the loan officer's financial analysis - during the loan approval committee & during control visits
- Be efficient when refreshing at each loan cycle
  - Draw conclusions from updated data
  - Monitor the loan suitability for the client

**Check Opportunity Bank Serbia's Loan Debt Threshold Calculator*

4. Measuring the risk of OID

Senior management and Board monitor the market and respond to heightened over-indebtedness risk.

→ Awareness of the top management unfolds in the whole institution:

- OID indicators and red flags are defined and monitored
- The infrastructure is organized for regular reporting
- Internal Audit provides feedback on whether policies achieve what they want to achieve

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

Sources of information

First available indicator is the **portfolio quality**:

- Monitored monthly (quarterly at least by top management)
- By branch, sector, product segment…
- When reaching a certain level, it triggers additional monitoring and response
- Rescheduled loans are tracked separately and considered at risk by nature

→ The MIS is organized for such reporting

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

- Analyze increased client exists
- Monitor clients who repay early in order to get new loans
- Train loan officers to identify and report cases of distress

Is the market crowded ?

→ **Market saturation** occurs when the provision of a service reaches the limits of a targeted client segment's effective demand

- this concept is difficult to measure

Signals of market saturation :

- Loan officers find it difficult to reach disbursement targets
- Multiple borrowing is very common amongst clients

MIMOSA

Microfinance Index of Market Outreach and Saturation

Another approach is the MIMOSA Index, based on market penetration and capacity

Case Study - Bangladesh

In 2008, Bangladesh faced a bursting credit bubble, with signals of market saturation.

The senior executives of the country's big four MFIs—ASA, BRAC, Grameen Bank and BURO, which represented 2/3 of the microfinance market – gathered to discuss the issue of multiple borrowings. No collective response could be found.

However, one after the other, these MFIs started slowing growth, individually reacting to 2 main problems:

- Market saturation started having a negative impact on their sustainability
- The rapid growth 2002-2007 had left some gaps in their credit management

→ Bangladesh avoided a potentially devastating microfinance crisis

Looking back, signals that become obvious later are often invisible or overlooked or brushed aside at the time.

Source: *A Microcredit Crisis Averted: The Case of Bangladesh*, CGAP Focus Note 87, July 2013

Remember!

- Uniformity across the institution is critical
  - Documented in policies
  - Effective and continuous training
- Sound repayment capacity analysis is based on the accuracy of the information you gather
- Continuous monitoring of products and data brings precious information
- A provider's awareness is built from the top to the bottom

What do you do when a case occurs?

You don't care and continue your collections process

You threaten there will be no other credit

You force the client to sell assets

You deprive clients from livelihood equipment

You lose the client relationship

What do you do when a case occurs?

You *do* care, and you evaluate the veracity of his situation

If he is indeed willing but unable to repay

Is it due to an unexpected event?

Or is it the FP's responsabil ity?

You also look at the market: is it an individual case? or is it a problem at a sector/region level?

While there is no universal solution, the response should be **client-centered**

Responding to over-indebtedness

- Clients should be informed that, if they face difficulties in paying back their loan, they *can* and *should* turn to the financial institution and speak with their loan officer

- The provider is responsible to **provide alternatives** to a distressed client.

Possible solutions:

- You ask the client to propose a solution
- You work out solutions with him to generate revenues
- You suspend payments during some time
- You agree to partial payments
- You reschedule
- You refinance
- and all the time you monitor closely

Stays in PAR

Needs a flag in the MIS

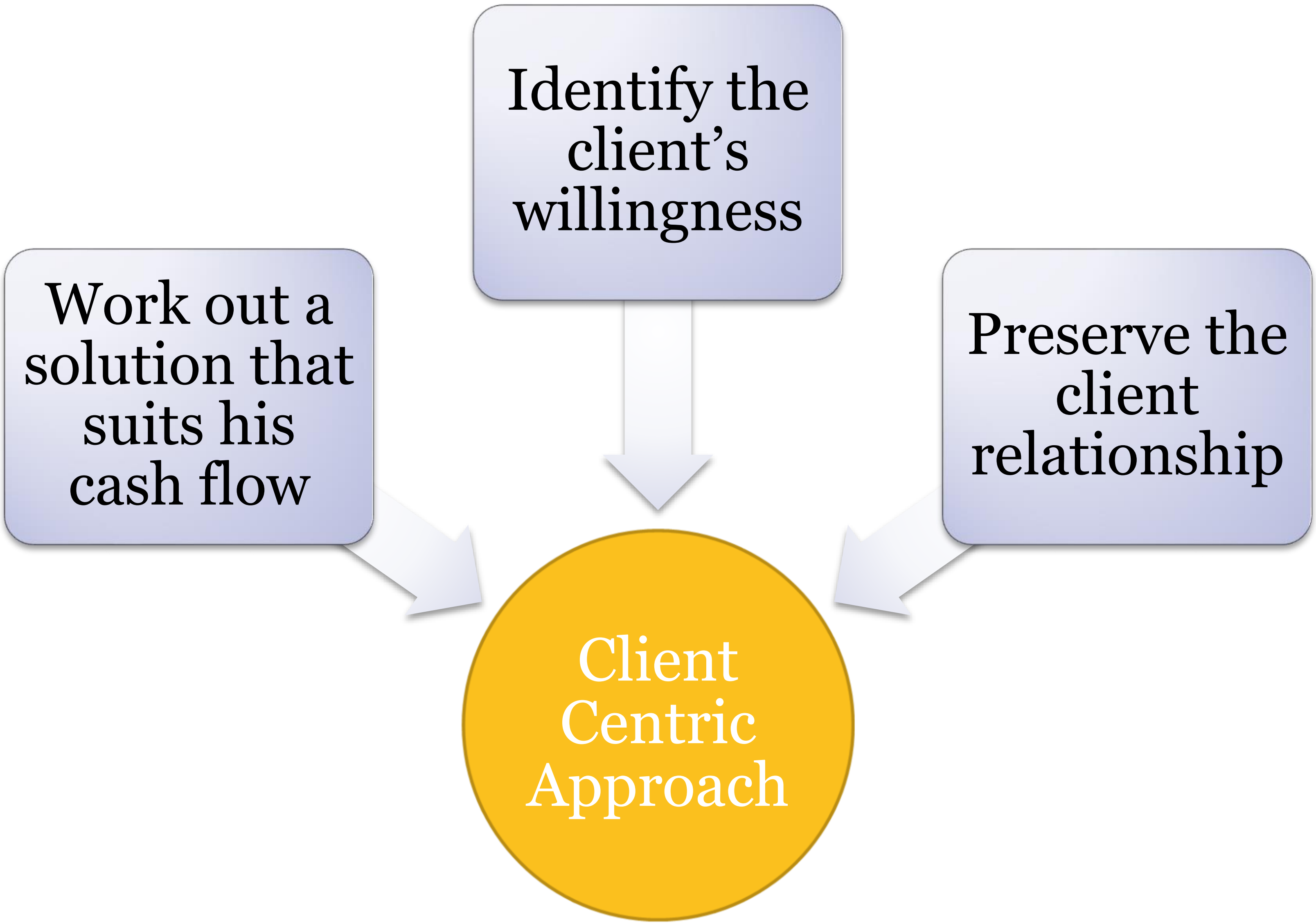
- In extreme cases, you write-off and relieve client from the debt

Staff training on collections

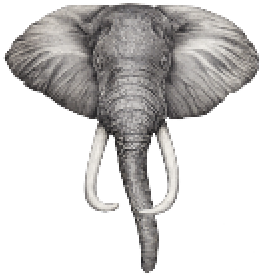
Critical for an effective response to over-indebtedness

- A specific module that addresses *the humane aspect* of collections.
- Train field staff on how to manage these sensitive situations:
  - Identify that a client is facing real distress
  - Or detect a fraudulent attempt
  - Engage a conversation without hurting the client
  - Have a good understanding of the institution's policy
  - Stay supportive but cautious while waiting for the committee's decision
  - Preserve the client relationship

Responding to over-indebtedness



Rescheduling: pros & cons

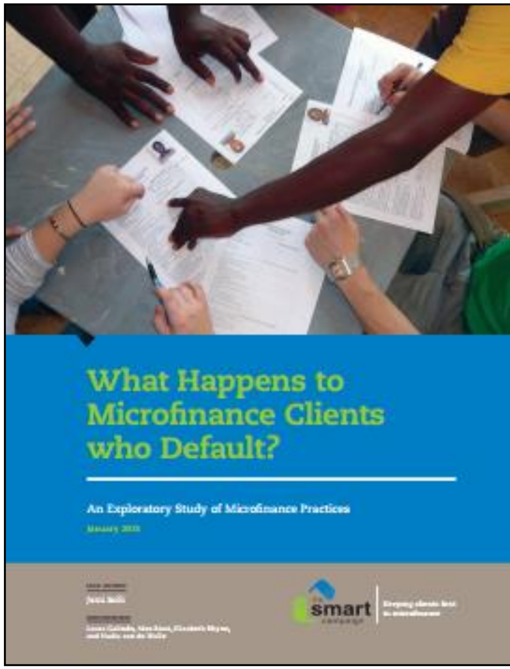


- Tremendous help for clients who need and deserve it
- Allows to gain reputation as responsible and humane lender
- Effective reward for responsible clients
- Bridges trust gap between client and lender

- Difficult to standardize
- If offered too late, doesn't help - if offered too soon, may be taken advantage of
- Unsustainable for financial institution
- Requires extra resources to verify client claims

Rescheduling is not always the right solution but should be always reserved as an option.

Collecting in a humane manner



Elements of humane collections:

- Treat clients with respect even when insisting on repayment.
- Keep collections private to the extent possible.
- Do not deprive clients of their basic human needs or ability to earn a living.
- Be flexible when it is warranted and feasible, and find ways to assist clients to rehabilitate themselves over time.
- And, of course, carry out collections in compliance with domestic law

One of the many highlights is the **lack of rehabilitation** for defaulting clients.

→ Providers should have a policy defining a definite time period after which the debtor's obligations end

→ Mediation and debt counseling mechanisms would help bring assistance to clients who are in distress

Solli, J. 2015. "*What happens to Microfinance Clients who default*". The Smart Campaign

Remember!

- Prevent, monitor and adjust!

- There isn't one answer to over-indebtedness, but there are ways of relieving a client from his distress with care

  → The most important is to have a client centric approach

- Managing over-indebtedness encompasses all of Product suitability, Transparency, Fair Treatment, Privacy and Complaints mechanisms

¿Questions?

Thank you for your participation!

The Responsible Microfinance Facility (RMF)

http://sptf.info/resources/responsible-microfinance-facility

The RMF offers the following trainings:

- Responsible Inclusive Finance Training
- Smart Assessor Training
- SPI4 Auditor Training
- Training TA providers on client protection
- Training TA providers on other elements of SPM

The RMF provides co-financing to financial institutions for the following activities:

- Accompanied SPI4 assessment plus additional support
- Client protection assessment
- Upgrade project
- Specialized training on an aspect of SPM
- Smart certification and/or social rating

Join us for the next webinar!

Thank you for your participation!