

Consumer credits for the poor – risk or opportunity?

responsAbility's Discussion Papers

responsAbility publishes Discussion Papers on a regular basis. They are aimed at providing state-of-the-art information on actual topics relevant to microfinance and to our clients. Their aim is to support the ongoing discussion with our partners, clients and stakeholders with the ultimate objective of developing a common understanding of key issues in the field.

Consumer lending evokes skepticism in both industrialized and developing countries. It is associated with provoking excessive indebtedness of clients and usury business practices. While microcredits serve to finance poor people's entrepreneurial income generating activities, consumer credits do not. So why then should Microfinance Institutions (MFIs) – whose core mission is to support productive purposes – offer consumer credits? Supportive arguments are: Productive loans are not always adequate to fight the multiple dimension of poverty. A variety of financial services is necessary to serve the needs of entrepreneurs, households or salaried workers. While concentrated on micro lending to small enterprises as their core activity, MFIs should have the possibility to offer to their clients the whole range of financial products, including consumer credits. But by doing so it is crucial that MFIs have a transparent product management and an adequate risk management in place.

The debate

Should microfinance institutions (MFIs) offer consumer credits? Due to the trend towards commercialization in the micro-finance industry, this question is increasingly the subject of an intense and often ideological debate. Traditionalists think that MFIs should not. According to their view, an MFI's core activity – driven by a social mission – is to offer entrepreneurs credit for productive purposes, thereby contributing to the developmental objective of poverty reduction. The pragmatists' view is different: They believe that an MFI serves the objective of creating an inclusive financial sector. Their argument goes that as not all poor have entrepreneurial skills. A single financial instrument such as the microcredit is not sufficient to

fight against the multiple dimensions of poverty. Thus an MFI's role is to offer the whole range of financial services including consumer credit. Although a consumer credit is not an income generating tool it can help to overcome bottleneck situations of the poor through its income smoothening effect.

Microcredit: Financing the entrepreneurial spirit

A microcredit is a small credit for poor entrepreneurs to finance productive business purposes. Typically, this type of lending is not secured by collateral but based on the client's ability to generate the necessary financial means for repayment based on his or her business activities. A credit analysis is applied which assesses if the borrower's business activity can guarantee repayment of the credit including interests. Knowledge of the industry, an analysis of the borrower's business as well as his social environment complete the information on which a lending decision is based. It is a complex and therefore costly procedure. But maintaining a high portfolio quality is critical for the lending institution because delinquent loans cannot be recovered by falling back on collaterals. An in-depth credit analysis is key to maintain a good portfolio quality. MFIs have developed sophisticated lending technologies and have managed to achieve outstanding portfolio quality.

Difference between consumer- and microcredit

Adjusted from FELABAN & WWB, 2005

| | Consumer credit | Microcredit |
|-----------------------|--------------------|--|
| Information base | Salary based | Business analysis and social context |
| Loan purpose | Consumer debt | Investment to create activities and income |
| Analysis | Desk analysis | Field visit in business and home |
| Client profile | Salary worker | Self employed |
| Credit administration | Standardized | Flexible and personalized |
| Debt objective | Consumption | Family business |
| Collateral | Salary | No traditional collateral required |
| Duration | Medium to longterm | Short to medium |

Consumer credit: Targeting salaried but poor workers

In contrast to microcredit, consumer credit has no defined financing purpose. Loans are approved based on the existence of a collateral. Clients are typically salaried workers. With this requirement met, additional information on the function of the credit has no relevance to the lender. In consequence credit analysis is simple, fast and can be handled at low operational cost. Consumer credit portfolios are often of lower quality because in case of default, it is relatively easy for the lender to fall back on collateral for loan loss recovery, typically the borrower's salary or in some cases the object purchased on credit. Thanks to these qualities and because it is often more flexible and dynamic than microcredits, consumer credit lending is a fast-growing market. Increasingly, consumer credit institutions are targeting low income clients and are entering the microfinance market.

The blending of the two credit types implies risks

The apparent common features such as small volumes, short maturity or target group have led to various forms of blending of the two credit types as the following examples illustrate: Bolivia: In the nineties, consumer credit companies pushed into the country's credit market, which until then was served by an already established microfinance market. To compensate for lacking local market know-how, the consumer credit companies, in lieu of carrying out their own credit analysis and demanding collaterals, settled for the information that an applying borrower was already client of an MFI. The lax credit handling and the growing and finally excessive offer of credits in the market resulted in a serious overindebtedness of poor clients and put the whole system at risk. The arising economic crisis caused the inflated system to collapse. Clients were insolvent, consumer credit institutions went out of business and MFIs, though most could sustain their operations, had to accept substantial credit losses¹.

South Africa: In contrast to other countries with a large informal sector, the South African microfinance market is characterized by the phenomena of working poors. What is called microcredit in South Africa is actually a consumer credit coming out of the formalization and expansion of informal consumer lending, rather than the development of income generation based on entrepreneurial lending. Historically, it has always been commercial institutions and not socially motivated MFIs serving these clients. This becomes manifest in the quality of lending portfolios, which is at an average loss of 10% on the portfolio, i.e. significantly above average micro credit portfolio loss of 2%².

These examples show that the blending of the two credit types has substantial consequences for all actors involved, for clients

as well as those offering credits.

In addition, there is also the client's perspective. Poor people's activities take place in the informal economy where a separation between working and living space is often absent. It is very likely that approved credits will finance an investment which serves multiple purposes: A motorcycle for example may be purchased and used for trading activities but may at the same time take the children to school. It can also be observed that family members with employment will request a consumer credit for productive purposes of family members. This is partly due to the fact that consumer credit is more easily accessible. On the other hand in places where microfinance is a relatively recent phenomenon, such as in Brazil, many micro entrepreneurs were and still are served by consumer lending companies for their productive activities.

What are the effects?

Considering these examples, what are the lessons learned? Negative effects become manifest where credit analysis and product character no longer match. Consequences on the operational level will materialize for MFIs as well as clients: Easy access to credit will lead to increasing overindebtedness of clients and as a consequence a decreasing portfolio quality for MFIs. In the end it will result in an increased sensitivity of the system to economic volatility.

Nevertheless, it might be tempting to MFIs to pursue an aggressive growth strategy based on consumer lending. However, an unprudential handling of the two types of credit poses a reputational risk for the concept of microfinance as a sound tool for poverty reduction. Excellent portfolio quality is the key argument of the industry's success because it proves the prejudice that poor people do not repay credit as not substantial. The Bolivian experience shows how easily public image can be damaged and how confidence in the entire credit system is affected.

Know and manage the risks to seize the opportunity

In order to mitigate the inherent risk of blending micro and consumer credits and still seize the opportunities of offering a variety of financial products to low income people, risk management should be established at three levels:

1. MFI operational level: MFIs have to be aware of the specification of each credit type and have to clearly differentiate between the two products on the operational level. This requires a well-defined methodology which matches the product. Monitoring and risk management must be in place.
2. Regulatory level: A specific regulation for microfinance banking is supportive to the development of a professional microfinance sector. It provides the banking supervision

¹ Rhyne, 2001

² Meagher and Wilkinson, 2001

body with the means to monitor and act upon non-compliance.

3. Client level: In an increasingly competitive lending environment, consumer protection is an issue of growing importance. Not least in support of the social mission closely linked to microcredit is it adequate to define measures for the protection of consumers, such as the establishment of a credit bureau, an institution both MFIs and clients can profit from.

These issues are taken into account in responsAbility's analysis of microfinance investment proposals. Although responsAbility supports the creation of inclusive financial sectors in order to allow MFIs to offer the whole range of services – in its investment activities, responsAbility remains focused on MFIs whose core competence is to offer microcredits and savings.

Sources and further readings

“Protecting Microfinance Borrowers”, CGAP Focus Note 27, May 2005.

Rhyne, Elisabeth (2001); Case Study “Crisis in Bolivian Microfinance”.

Meagher, Patrick and Betty Wilkinson (2001) Filling the Gap in South Africa's Small and Micro Credit Market: An Analysis of Major Policy, Legal, and Regulatory Issues.

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responsAbility Social Investments AG

Josefstrasse 59, 8005 Zurich, Switzerland
Phone +41 44 250 99 30, Fax +41 44 250 99 31
www.responsAbility.com