Is Microfinance Too Rigid?

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> Sameer is a farmer who subsists on three acres in rural India. While much of the land is fertile, nearly 50% of his income goes towards just the interest payments from money-lender loans, loans which are necessary to finance the crops he plants. Moreover, some of his land is unused because he cannot profitably finance irrigation at the money-lender's rates (5 to 10% per month). As a result, his family's nutrition and education are compromised.
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> Angela runs a small provisions shop in the city. For her business she has many financing needs from working capital to longer term investments. Luckily there is an MFI nearby which she uses. Yet she only uses it to finance a part of her needs. For the remainder she chooses to use the money lender who charges a much higher rate, even though she could borrow more from the MFI. When asked why she responds that she likes the money lender's "flexibility" that she can skip payments during the hardest weeks.

We feel these two examples illustrate how, despite years of stunning growth, MFIs still fulfill only a small fraction of the financial needs of the poor.

Being poor is not just about having too little income. It is about having insecure income. The income of the poor can vary dramatically from day to day, month to month, season to season. Contrast this with the single most salient fact of micro-finance: nearly all contracts are fixed in their repayment schedules. This mismatch between debt payments and income can create serious distortions. Are these distortions inevitable? The implicit presumption is that they are. Many good reasons have been articulated for using fixed debt contracts.

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 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 was 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 (e.g., floods or droughts), they may (should!) use the flexibility to help smooth out those shocks. This has implications to the lender, if they are seeing a shortfall in repayment at the exact moments they want 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, can claim that the client exercised their "flexibility" when in fact they repaid. Proper internal controls should be able to mitigate this risk, but it is an impediment nonetheless.

Lastly, 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 ROSCAs and chit funds exist, to provide individuals a commitment to save. If the debt requirement allows some flexibility, some fear 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.

First, rigid contracts may greatly constrain loan size. If I earn 50Rs some weeks and 550 Rs other weeks, my debt capacity is not based on my average income of 300Rs but on the 50Rs that I can afford to pay in the bad weeks. As a result, borrowers with variable income and little means outside of money lenders to smooth that variability will be given a debt capacity much lower than ideal.

Second, flexibility can actually *save* on loan officer time. If every monsoon, we know 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?

Third, the rigidity of contracts may effectively be keeping some lucrative borrowers from borrowing. Client retention is an issue for many MFIs. Perhaps many leave because they experience too many "close calls" and then drop out in order to avoid going into default. Or perhaps out of this fear, they never join in the first place. Thus flexibility may increase client retention and help attract more clients. Ironically, these clients who leave, or never join, because of fear of default are dream clients for the MFI. They are clients of such strong integrity that they refuse to borrow for fear of defaulting.

Finally, 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 under-feed during difficult times. Asset owners may sell off (productive) assets to repay debts. Flexibility would prevent the destruction of this value and could be as useful as the initial loan itself. Relatedly, this increased income could actually allow the MFI to further increase loan size.

Given these benefits, how can we practically implement flexibility in the current micro-finance structure? We give three examples, each highlighting a different element of flexibility.

First, we observe that flexibility can be *pre-built* into the contract. For example, the monsoon is a difficult time for everyone. Contracts could reflect this by reducing payments during this period in a pre-specify manner. Similarly, dairy farmers face two months a year without milk. Again, the contract could pre-specify a smaller loan during this period. Pre-specification of flexibility has many benefits. Notably, the client does not feel 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 concerns of MIS, cash management and loan officer fraud.

Second, one could provide less rigid flexibility by pre-specifying 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 a great deal of flexibility.

Finally, consider an MFI who feels that their borrowers could handle 2,000Rs higher loans than they currently receive. Should they just increase the initial loan size? What if instead they told all borrowers that they would be eligible for a 2,000Rs second 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 since it gives the client a safety valve in case of emergencies.

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 waters? There is only way to know if microfinance can be more flexible: to test flexibility.

Much remains unknown in microfinance. We focus here on one issue in particular: the flexibility or rigidity of debt products. Nearly everyone feels they know how to structure a microfinance loan. Yet everyone differs on the answer. We label these as unknown not because nobody knows the answer but because we all "know" different answers. The goal of our research around the world, as with the Center for Microfinance in India, is to bring about consensus.