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Can it Help the Poor if it Hurts the Banks?

Credit risk is a reality for banks around the world. It is even a fairly predictable reality, if sometimes ignored (Exhibit A: Present dynamics in the US). Banks often know what percentage of their loan portfolio is at risk and they price that risk through higher interest rates for riskier clients, among other ways. Microfinance institutions (MFIs) do not have the same luxuries. They lack the information about their clients necessary to differentiate, they already get enough flak about their "high" interest rates, and they are constantly fighting to keep operations costs low, a difficult task if you increase complexity. It's no wonder, then, that low client default rates have become a kind of holy grail for microfinance providers. When you feel powerless to change so much of what you do, its useful at least to have a clear measure of commercial success.

And yet, could the rigidity of the typical micro-credit product be partially responsible for the fact that access to credit has limited, if any, income effects for micro-entrepreneurs? Could it be that microentrepreneurs are intentionally shying away from higher risk, higher return investments because the banks require that they begin paying back the loan within a week after they receive it? That was the operating question for a study presented at the Microfinance Impact and Innovation Conference by Erica Field from Harvard.

To recap, the traditional micro-credit loan is offered to women in a group liability structure; the loans are typically given with the intent that the women will either start or continue to support a business. The women meet once a week with the loan officer to make payments, and those payments start the first week after the loan is given. (A number of studies have shown that moving to monthly meetings and repayment does not effect default rates. Field conducted one such study in India, and the participating bank changed its loan structure as a result, since it saves in operations costs. That same bank is the partner in this study presented by Field as well.)

Field looked to the developed world for a model: In the US, small business loans typically have a "grace period" of at least a few months before the business owner is required to begin loan payments; those payments also typically occur in a monthly cycle, not weekly; and the default rates are much higher than micro-credit defaults (between 13 and 15 percent default compared to the 4 or 5 percent default seen from microfinance clients). With that approach in mind, Field worked with a Village Welfare Society in India to implement a credit product that introduced a two-month grace period after the loan was dispersed and before the client needed to start paying.

The results showed that clients with the two-month grace period on average enjoyed 25 percent higher profits than clients in the control group. They invested 10 percent more of the loan in the business, and increased inventories and outputs by two thirds. Household income also seemed to increase in the period.

Those numbers imply that increasing flexibility in loan terms has positive effects for some micro-credit recipients. Yet the study showed some important nuances. Most relevantly is that the results varied widely—a group of recipients with grace periods did dramatically better, but some did dramatically worse (that 25 percent increase in profits is only the average). In addition, defaults for the bank increased, reaching 12 percent of the “grace period” group, compared with slightly more than 4 percent for the control.

The outcome? Field reports that the bank does not plan to implement grace periods for its microenterprise clients. Why would it? It would amount to taking more risk and earning less in order to help some clients earn more.

But don’t write off this study yet. Given the puzzle of helping microentrepreneurs increase incomes, it is worth exploring how banks can identify those more likely to succeed from those more likely to fail and introduce the two-month grace periods for the former group. Such easy-to-use measures might be a win for everyone. More on that subject in coming posts. Stay tuned…

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