Innovations for Poverty Action

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Measuring Use of Loans

A recent post from Alex in the Philippines addressed the common uses of microfinance loans, which leads logically to two follow-up questions. How do we actually know with any certainty what microfinance clients do with their loans given that money is fungible? And, secondly, should we care as long as the loans are paid back?

Many microfinance institutions insist that their loans be used for productive purposes, mainly because they want to help poor households generate revenues, and also because they want to ensure that people will be able to repay. In fact, they often collect information on loan usage from their clients and report it on their website. However, measuring usage is no simple matter. If loans are officially restricted for business investments, clients may not report using some or all of the funds for consumption. Even with perfect reporting, there’s another issue. Imagine that a microfinance client reports that she took a loan of Rs. 5000 and bought a sewing machine that costs Rs. 5000. In her own mind, she used the loan for the intended purpose, but because money is fungible, how do we know that she bought the sewing machine with her loan and not with her savings? In other words, perhaps she would have bought the sewing machine regardless of whether she got the microloan by using her own savings or a money lender for example. So the real usage (or impact) of the loan is not the sewing machine, it is the money she saved by borrowing at a lower rate and how she used the interest savings.

That brings us to the question of whether or not MFIs should care about how loan funds are used. On the one hand, it’s possible that MFIs are too conservative in their insistence that clients borrow only for productive purposes. On the other, understanding the specific uses of loan funds can help design better products and maximize the impact of microcredit. At a conference organized by the College of Agricultural Banking and the Centre for Micro Finance in 2008, Jonathan Morduch mentioned that the question is not whether loans should be used for consumption or not, but how to best embrace the reality and address clients’ needs while not jeopardizing repayment capacity. For example, MFIs could provide emergency loans to clients who have proven able to repay. If micro-loans help clients pay for school fees, why not design an education loan that is timed with the school year or, perhaps more appropriately, offer an education savings product? To channel microloans to more productive uses, perhaps innovative product design, tested through randomized trials, may be much more effective than setting upfront requirements on the use of funds.

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