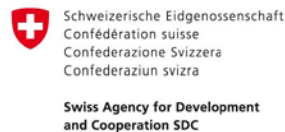


OVERINDEBTEDNESS: EVIDENCE, CAUSES AND CONSEQUENCES

Sylvia Wisniwski



EFSE – a Development Finance Initiative supported by



Contents

- Defining and Measuring Overindebtedness
- Empirical Evidence of Overindebtedness
- Causes of Overindebtedness
- Strategies and Approaches to Address Overindebtedness
- Towards Early Warning Indicators of Overindebtedness

Definitions of Overindebtedness

There is no generally accepted definition, but ...

“If repayment becomes an insurmountable burden, a client becomes over-indebted”

— Tor Gull, Oikocredit Managing Director

“Overindebtedness is an outcome of a loan contract that does not correspond to the original expectations of the borrower, the lender, or both.” — Adrian Gonzalez, Lead researcher for MIX

“A person is considered overindebted when he or she is objectively unable to pay, that is to say his or her income, after deduction of living expenses is no longer sufficient to meet the repayment of debts [for a long time period] as they fall due.”



— Ulf Groth, German Debt Adviser, Member of Consumer DebtNett (CDN) Working and Funding group

“If a family has to make sacrifices that significantly affect their quality of life, or if a micro-business has to make sacrifices that reduce its income generating capability, that's debt stress.” — Richard Rosenberg, CGAP

“Overindebtedness can only occur if there is a previous acquisition of credit. (...) [It] occurs when a commitment falls due which cannot be met from foreseeable income in the long term.” — Prof. Dr. Jur. Udo Reifner, Institute for Financial Services (IFF, Hamburg)


Measurement of Indebtedness

Guidelines of different lenders for maximum debt exposure

 <p>FMO Finance for Development</p>	Microenterprise loans	30 - 50%
 <p>Triodos Bank</p>	Microenterprise loans	50 - 70 %
	Consumer loans	20 - 30 %

EFSE definition of overindebtedness

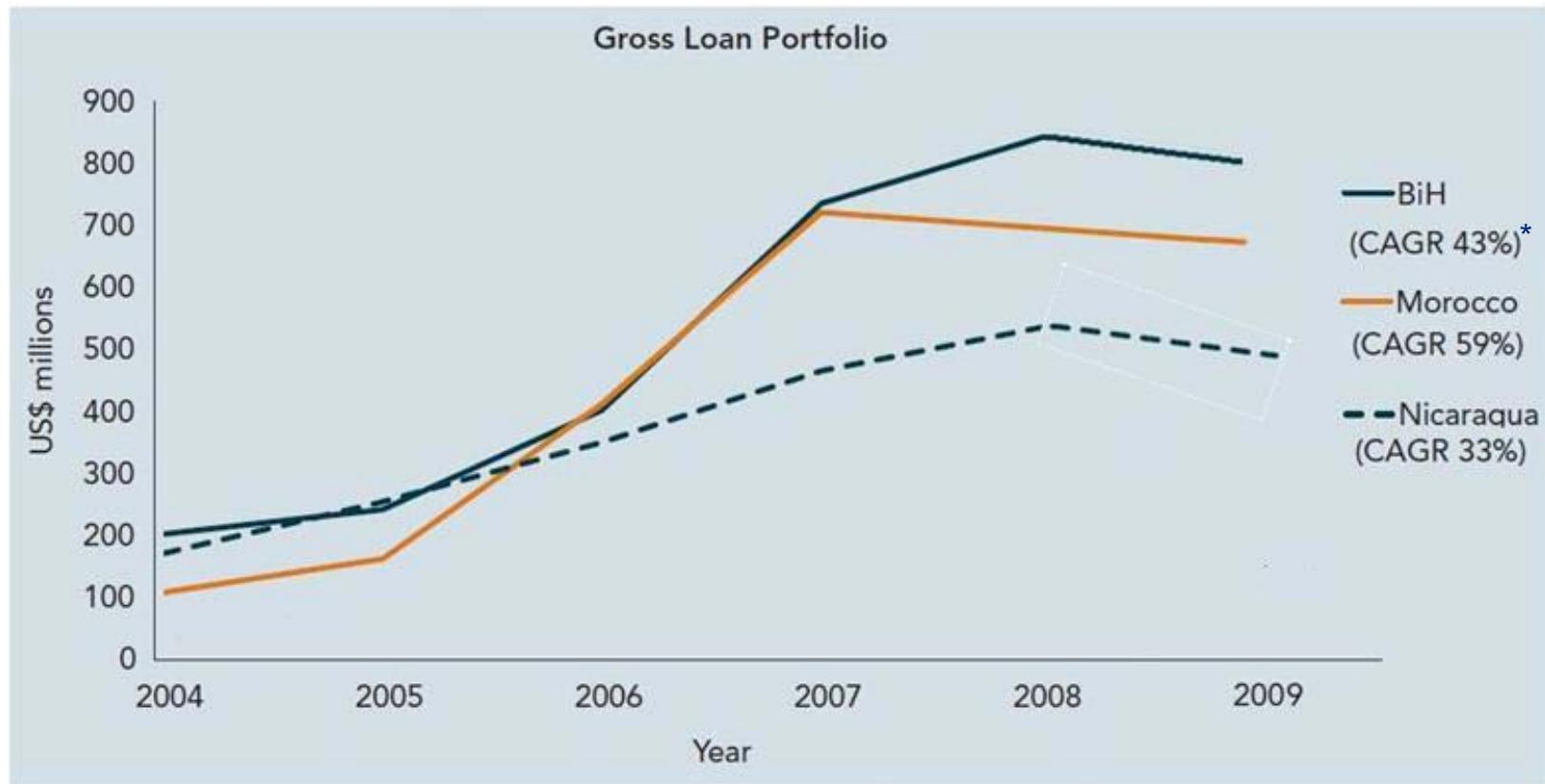
$$\frac{\text{Sum of monthly debt service}}{\text{Monthly net income}^*} = \% \quad \text{Net Indebtedness Index}$$

 <p>EUROPEAN FUND FOR SOUTHEAST EUROPE</p>	Overindebted	> 100%
	At risk of becoming overindebted	75%-100%
	Not overindebted	< 75%

* Net monthly household income = total monthly gross income – total monthly expenses

Empirical Evidence of Overindebtedness

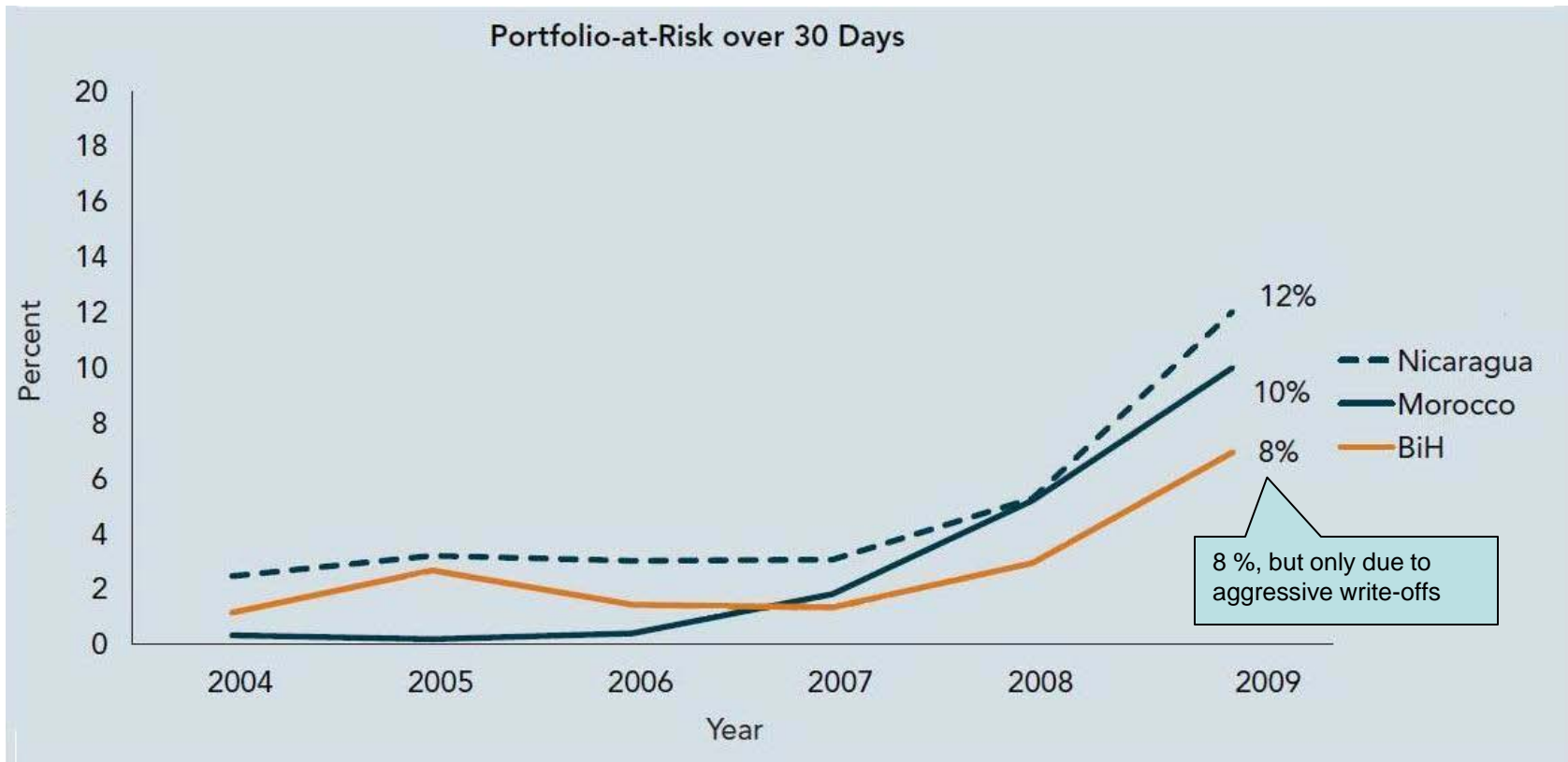
“Overindebtedness can only occur if there is a previous acquisition of credit. “



Source: “Growth and Vulnerabilities in Microfinance”, February 2010, CGAP and MIX Market
* CAGR – Compound Annual Growth Rate

Empirical Evidence of Overindebtedness

Overindebtedness as major cause of repayment problems



Source: "Growth and Vulnerabilities in Microfinance", February 2010, CGAP and MIX Market

Empirical Evidence of Overindebtedness

Bosnia and Herzegovina portfolio ratios

	2006	2007	2008	2009	June/ 2010
Portfolio at risk (over 30 days)	0.9%	1.0%	2.5%	8.3%	10.5%
Rescheduled portfolio	0.1%	1.0%	5.1%	1.3%	6.4%
Affected loans	1.0%	2.0%	7.6%	9.6%	16.9%
Write-offs	1.6%	0.04%	1.6%	7.9%	7.0%

Source: Association of Microfinance Institutions in Bosnia and Herzegovina

Empirical Evidence of Overindebtedness

“Overbanking” of microcredit clients

	BiH	Morocco	Nicaragua
Number of MFI	13	10	22
Number of microfinance borrowers	374,966	919,025	379,868
Number of microenterprises	151,107	661,636	366,000*
GDP per capita	USD 4,278	USD 2,865	USD 972
Gross loan portfolio outstanding (MFIs)	USD 832.8 million	USD 611.7 million	USD 460 million

Loan amount outstanding/ Microfinance borrowers	USD 2,221	USD 666	USD 1,211
Loan amount outstanding/ Microenterprises	USD 5,511	USD 925	USD 1,250
Loan amount outstanding MFIs+Banks/ Microenterprises	USD 8,909	n.a.	n.a.

Microfinance borrowers / MFI	28,844	91,903	17,267
Microenterprises / MFI	11,624	66,164	16,636
Microfinance borrowers/ Microenterprises	248%	139%	104%

Source: IMF, EFSE database, MIX Market. Data as of 2009.

* Number of micro and small enterprises, 2005

The Case of Nicaragua

Nicaragua: Repayment crisis – a consequence of overindebtedness?

- 350 MFIs*, high level of market saturation favoured the crisis
- Large presence of donors and high capital inflow from international investors
- Fast expansion of microcredit loan portfolio – compound annual growth rate of 33% between 2004 and 2008
- 40% of active borrowers have loans from more than one MFI
- Delinquency crisis affected all 22 major MFIs
- *The “No pago”* movement received support from ruling party
 - ➔ Press coverage widened and deepened the repayment problems
 - ➔ Includes around 5,000 producers, merchants and microentrepreneurs

Source: CGAP, MIX Market

* Including all players, i.e. savings and credit cooperatives, NGOs etc.

The Case of Morocco

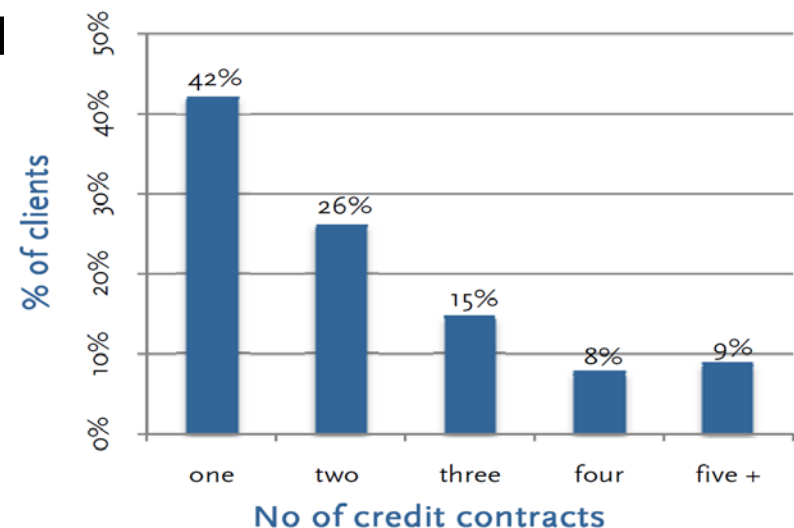
Morocco: A recognised microfinance champion struggles

- 40% of client outreach in Arab world
- Average amount of credit contracts per borrower ~ 1,3
- Heavy concentration
 - Four largest MFI account for 90% of client outreach
- Unprecedented growth overstretched MFIs leading to:
 - Lenient credit policies, obsolete management information systems, lack of internal controls and substandard governance
- Since 2007 microcredit sector crisis
 - NPL has risen from 0,42% in 2003 to 10% in 2009
 - Zakoura, one of the flagship institutions, reported a PAR 30 of over 30% and merged with another MFI

The Case of Bosnia and Herzegovina

Bosnia and Herzegovina: “Overbanking” of microenterprises

- 58% of microcredit clients have more than one active credit contract
- Average number of credit contracts per borrower ~ 2,3
- 38% have additional bank loans with total amounts borrowed considerably higher than their MFI borrowings
- The majority of clients cross-borrow from several different microcredit institutions and commercial banks
- Taking multiple loans is correlated with providing guarantees for others: 34% of clients act as guarantors
- PAR 30 reaches 13% in 2009



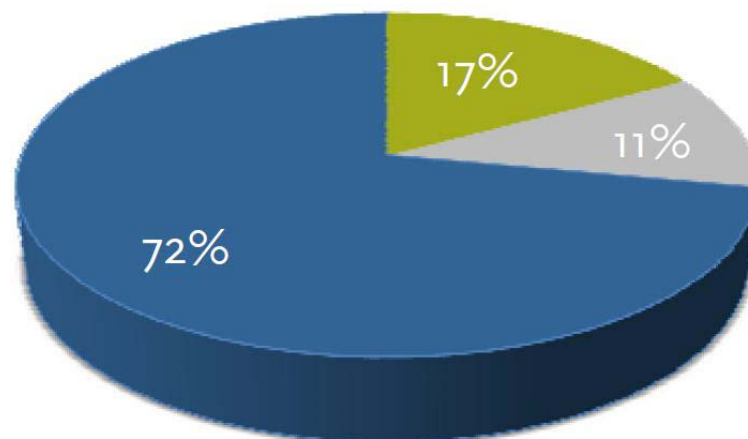
Source: EFSE data

The Case of Bosnia and Herzegovina

Bosnia and Herzegovina: “Overbanking” of microenterprises

- 28% of microcredit clients are at risk to be overindebted or are already overindebted.

Level of Indebtedness



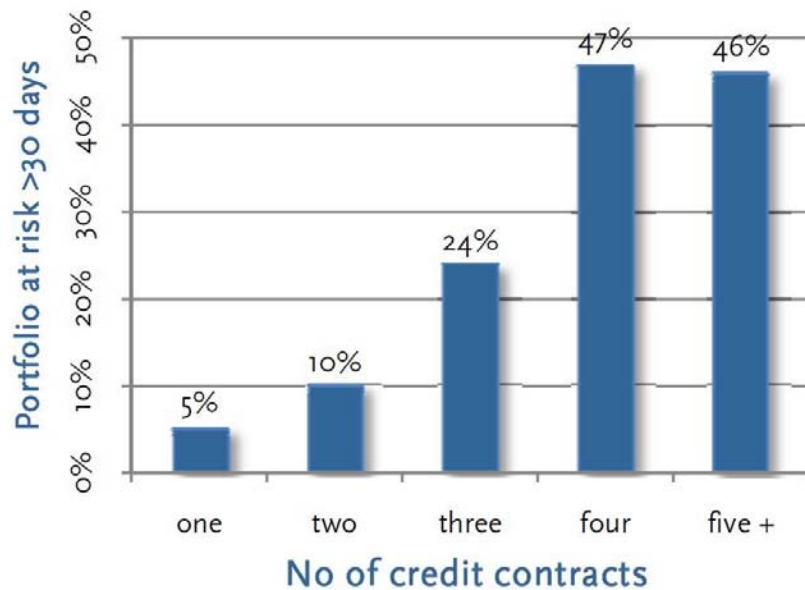
- Overindebted
- At risk of becoming overindebted
- Not overindebted

Source: EFSE data

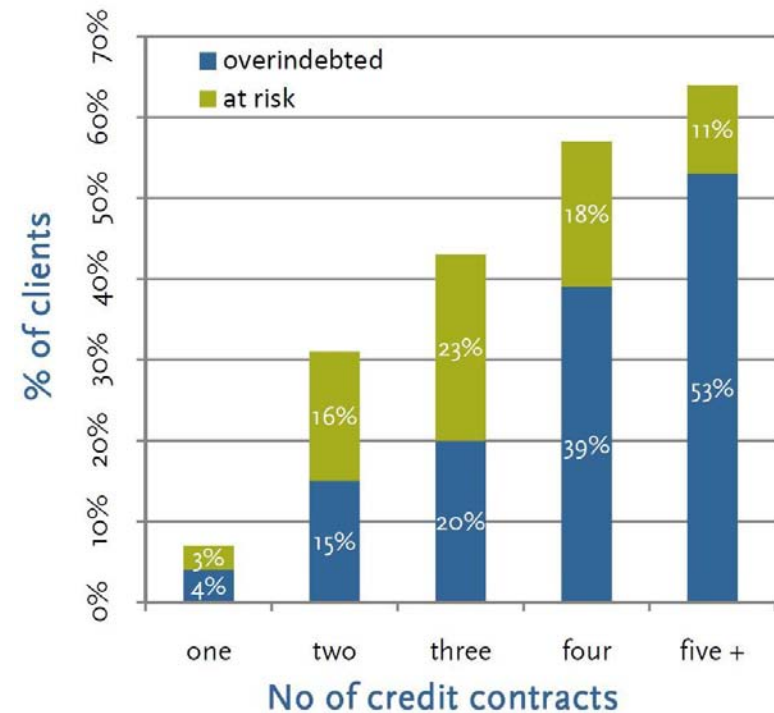
The Case of Bosnia and Herzegovina

Correlation between multiple borrowing and repayment performance & overindebtedness

Multiple Borrowings and Repayment Performance



Multiple Borrowing and Overindebtedness



Causes of Overindebtedness

Demand Side

- Deterioration of economic conditions
 - Low economic growth/ stagnation
 - Increase of unemployment
 - Inflation
 - Higher expenses and lower or untimely income flows
- Evolution of an easy credit culture
 - Overestimation of own repayment capacity
 - Lax discipline in repayment of loans
 - Expectations toward creditors to solve the problem

Causes of Overindebtedness

Supply Side – financial institutions

- Fierce competition among credit providers
- Riskier lending
 - Persuasive sales techniques
 - Quicker disbursements
 - Relaxing assessment of repayment capacity
- Fast institutional growth
 - Less experienced staff
 - Lower quality of capacity building for middle management
 - Inadequate internal controls

Causes of Overindebtedness

Supply Side – financial sector

- Lack of industry standards (code of conduct)
- Lack of transparency on client indebtedness:
late arrival of credit bureau
 - Multiple client borrowing from multiple institutions
- Capital inflow to banking and microfinance sectors
 - Abundant debt funding available
- Investors' expectations of scale, market share and profitability
 - Incentivised for unsustainable practices
 - Neglected thorough assessment of real finance demand and capacity

Strategies and Approaches to Address Overindebtedness

Microcredit providers

- Limit credit exposure per client
 - Limit number of concurrent credits
 - Limit maximum debt levels in relation to income
- Reduce incentives for cross-borrowing from multiple institutions
- Strengthen loan appraisal
 - Make client visits obligatory
 - Assess cash flow analysis systematically
- Reduce reliance on guarantees and disentangle interdependence of borrowers and guarantors
- Improve client financial literacy

Strategies and Approaches to Address Overindebtedness

Association of MFIs

- Promote responsible lending and develop indicators and minimum standards of conduct
- Establish an audit function and regulations sanctioning non-compliance with the code of conduct
- Strengthen coordination and cooperation among all financial institutions

Investors and creditors

- Support microfinance industry in the development of standards for code of conduct
- Include the assessment of compliance with the standards of code of conduct into due diligence
- Offer local currency lending/instruments

Strategies and Approaches to Address Overindebtedness

Credit information bureaus

- Harmonise and define risk classification methodology
- Harmonise the reporting method
- Clearly mark restructured loans
- Introduce real time data uploads by financial institutions
- Create more user-friendly output for financial institutions
- Conduct trend analysis of comprehensive credit registry data

Regulators

- Consolidation of the microfinance sector
- Resolve the status of ownership and introduce good governance
- Adopt the high standards in credit management and financial discipline as applied to commercial banks
- Ensure full compliance with the standards

Towards Early Warning Indicators

The development of early warning indicators: work in progress

- It is difficult to assess over-indebtedness at an early stage as the problem is complex, often not visible early on, and caused by multiple factors.
- Factors on the macroeconomic, sectoral/market, institutional and client level and their linkages need to be taken into consideration.
- Some factors provide a clear hint for a possible over-indebtedness problem in a market, e.g.:
 - Strong portfolio growth of microcredit providers
 - Number of outstanding loans per borrower
 - % of clients holding loans with multiple institutions („cross-indebtedness“)
 - Non-existence of a credit bureau and/or non-participation of MFIs in the bureau
- ➔ Additional empirical research and joint efforts are required to develop early warning indicators (EFSE DF research in Kosovo)

Thank you for your attention!



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Contact:

Sylvia Wisniwski, Chief Operating Officer for EFSE

Phone: +49 69 9778 7650-50, Fax: +49 69 9778 7650-10, E-mail: info@efse.lu