The Risk of Over-indebtedness of MSE Clients in Kosovo

Results from a comprehensive assessment

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OBJECTIVES OF THE STUDY

In 2010/2011, the Development Facility of the European Fund for Southeast Europe commissioned a study to assess the incidence of over-indebtedness of microcredit clients in Kosovo. The analysis of the results of the study, focused on the over-indebtedness of clients with enterprise loans up to EUR 10,000. This revealed moderate levels of over-indebtedness among the target group. Credit registry data showed that 25% of clients held more than one active credit contract and that the average number of loans amounted to 1.4 per client. Twenty-five per cent of clients faced a certain critical degree of over-indebtedness.

In order to gain a more comprehensive picture of the problem of over-indebtedness in the country, the Facility commissioned a second study in Kosovo to assess whether there is a problem of (over)indebtedness among borrowers with larger loan amounts, i.e. EUR 10,001-50,000. This study aimed to complement the results of the first study and was the fourth over-indebtedness study carried out by the Facility. In addition to the first Kosovo study, such research has also been conducted in Bosnia and Herzegovina and Azerbaijan.[1]

The latest Kosovo study aimed to analyse the seriousness of the problem of over-indebtedness in the micro- and small enterprise (MSE) segment with research questions centred around assessing the factual incidence of indebtedness as such and the likelihood of over-indebtedness. Following the comprehensive assessment of demand- and supply-side factors that in some cases led to or in other cases prevented the over-indebtedness of microcredit clients, which emerged from the first research project, it was decided that this second study would focus on the compilation and analysis of Credit Registry and management information system (MIS) data only and on developing further recommendations as to how the sector could address the topic of over-indebtedness.

METHODOLOGY

Sample. The study was conducted between April and October 2012 and comprised the compilation and statistical analysis of credit registry and MIS data from financial institutions. The sample comprised 2,200 borrowers, divided into two sub-

[1] Summary papers on the results from the assessments in Bosnia and Herzegovina, Kosovo and Azerbaijan are available from the EFSE website (www.efse.lu).

samples: **segment 1** consisting of clients with loans of EUR 10,001-25,000 at disbursement and **segment 2** consisting of clients with loans of EUR 25,001-50,000 at disbursement. This segmentation reflects the the new national regulation, which defines microfinance as including loans up to EUR 25,000.[2] As the results of the study revealed that both segments are very similar in terms of borrowing patterns and indebtedness levels, results for both segments were summarized for the purpose of this paper. Differences between the segments were highlighted when they were deemed to be striking and meaningful.

The sample was drawn up proportionately by the nine participating financial institutions (five banks and four microfinance institutions (MFIs)), reflecting each institution's share of the credit market in the two segments. Clients of participating institutions were randomly selected to assure the validity and representativeness of the data. Given the scale of outreach of the participating institutions the results stand for about 82% of the credit market in terms of the number of borrowers, based on CRK figures. In contrast to the first study, the client samples were selected from the total population of credit users in the respective segments and not only from amongst clients with business loans.

The quantitative analysis was conducted based on secondary data from two sources, including (i) data on borrowing and guarantees as of 30th June 2012, as reported to the Credit Registry of Kosovo (CRK), which is administered by the Central Bank of Kosovo (CBK); and (ii) data on household demographics and income from client files of the participating credit providers. The analysis resulted in a fair picture of the borrowing patterns and the (over)indebtedness levels of the clients in the sample.

Data limitations. The research faced several data limitations, such as the lack of precise monthly repayment information (CRK does not collect such information) and a time discrepancy between CRK data on debt obligations and the information on household and business incomes, which was collected by the participating financial institutions at the time of disbursement. The income data was on average 18 months old. The study followed the assumption made by the financial institutions that the value of income reported/determined at the time of disbursement would be stable, or at least not lower, during the loan term, thus allowing the borrower to repay the loan without problems. However, the assessment revealed that some of the borrowers were granted additional credit after the loan disbursement used in the study, so it is likely that their income had increased sufficiently to make them creditworthy for additional debt. However, 'old' income data was still used and therefore possibly over-estimated the indebtedness level of borrowers in this market segment.

Sample characteristics. The vast majority of borrowers (82%) were men and residents of urban areas (90%). The average household of the borrower had a net (disposable) income of EUR 2,900. The MSE clients ran businesses which were predominantly engaged in services (43%) and trade (30%). Three quarters of the businesses had been in operation for more than six years. The average monthly gross income of a business was about EUR 34,000.

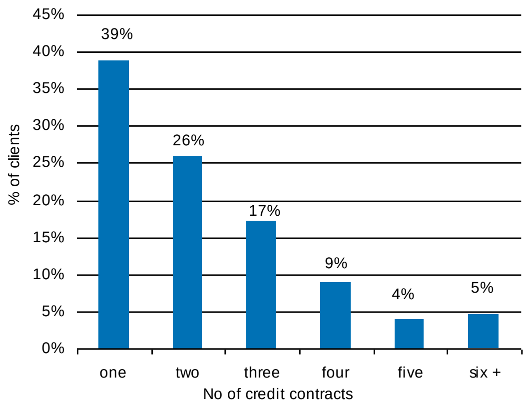
BORROWING PATTERNS

Almost two-thirds of borrowers had multiple loans. Credit registry data showed that only 39% of clients had just one active credit contract, while 61% had two or more credit contracts outstanding (chart 1). Clients had on average 2.3 outstanding credit contracts, with a maximum of 24. Clients

2 The new law on banks, microfinance institutions and non-bank financial institutions became effective in April 2012.

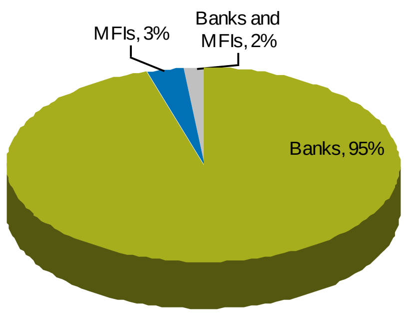
from segment 2 (larger loans) were more likely to have five or more credit contracts than clients from segment 1. Regular loans from banks were the most common product but overdrafts and credit cards were also frequently used: overdrafts constituted 20% and credit cards 13% of all active credit contracts of the clients in the sample.

Chart 1: Multiple borrowings



Cross-borrowing was common, but relatively rare from different types of institutions, as the majority of borrowers were bank clients. As a result, only 2% of all borrowers in the sample were clients of both banks and MFIs (chart 2). However, cross-borrowing between different institutions – mainly banks - was practised on a large scale.

Chart 2: Source of credit (% of clients)



Cross-borrowing from different institutions increased with the number of active credit contracts. On average, one client used the services of 1.48 different institutions concurrently; in the most extreme example, one client had loans from 7 institutions at the same time.

REPAYMENT PERFORMANCE

10.3% of clients were overdue on their loan repayments for 30 days or more. While the majority of clients (89.7%) managed to make their monthly repayments on time or within 30 days, 6% had at least one contract in arrears between 30 and 180 days and 4.3% were overdue for more than 6 months (table 1). The total value of the outstanding portfolio with overdue amounts for over 30 days was 10.2%. Among overdue clients, the majority were late on just one credit contract. Clients from segment 2 performed significantly worse, as 11.9% of borrowers were overdue for more than 30 days compared to segment 1 clients where 8.6% were late on their repayments.

Table 1: Repayment performance

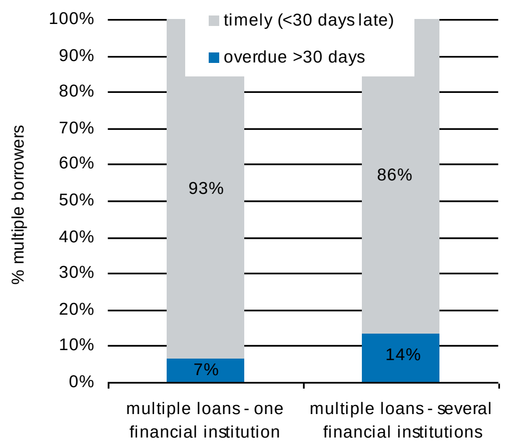
Repayment	% clients	% portfolio
On time or overdue < 30 days	89.7	89.8
Overdue 30-60 days	2.7	1.6
Overdue 60-90 days	1.6	0.7
Overdue 90-180 days	1.7	2.3
Overdue >180 days and written off	4.3	5.6
Total	100	100

Repayment performance started deteriorating in 2009. The share of delayed repayments slightly increased in 2009 compared to 2008, as it grew to 1.9%. In 2011, it had already reached 4.4% and it further increased in 2012. During the first 6 months of this year, it was noticeable that a further increase had occurred to 6% of monthly repayments being overdue for more than 30 days.

Overall, the study identified a number of factors that influenced the repayment performance:

Repayment problems are more frequent among clients who borrow from several institutions. While the depth of repayment problems increased with the number of loans only among segment 1 clients, the repayment performance of clients from both segments was sensitive to cross-borrowing from several institutions. While 7% of multiple borrowers with all outstanding loans from one institution were overdue by more than 30 days, the figure increased to 14% among borrowers who were indebted to several institutions (chart 3).

Chart 3: Cross-borrowing and repayment performance



Experienced borrowers tended to be less disciplined and repay in a less timely fashion. While only 5% of first-time borrowers were overdue for more than 30 days, as many as 11% of clients who had borrowed in the past were late on monthly dues.

Repayment performance on MFI loans was worse than on credit contracts from banks. Four times as many MFI contracts (24%) were overdue by more than 30 days as compared to those held with banks (6%).

Repayment discipline loosened as loans drew closer to maturity. Of loans which were already more than halfway through their term, 7.4% were repaid with at least a 30-day delay, while only 2.6% of those in the first quarter of the loan term were overdue for more than a month.

Loan contracts with larger original amounts were more often overdue. Loan contracts that were overdue by more than 30 days were on average larger by 50% at disbursement (EUR 22,180 versus EUR 32,950).

OVER-INDEBTEDNESS

Definition. The level of indebtedness was assessed using two measures. For those clients whose net income data were available, the household net indebtedness index was calculated using the following formula:

- *Total monthly instalments on debt/net monthly household income.*[3]

For those borrowers for whom only business income data were obtained, the business net indebtedness index was calculated using the following formula:

- *Total monthly instalments on debt/net monthly business income*.

In total, the household net indebtedness index was calculated for 60% of clients and the business net indebtedness index was calculated for 32% of the sample. For 8% of borrowers, the indices were not calculated because of the lack of net income data.

Based on the index calculations, clients were classified into four groups:

3 Net monthly household income = total monthly gross income of the household minus total monthly expenses of the household

- *Insolvent* – defined as a net indebtedness index equal to or exceeding 100%, i.e. the client spent all his/her net household income or business profit on debt
- *Critical* – defined as a net indebtedness index of between 75% and 100%, i.e. the client spent between 75% and 100% of his/her net household income or business profit on debt servicing
- *At risk of becoming over-indebted* – defined as a net indebtedness index of between 50% and 75%, i.e. the client spent between 50% and 75% of his/her net household income or business profit on debt servicing
- *Not over-indebted* – defined as a net indebtedness index below 50%, i.e. the client spent less than 50% of his/her net household income or business profit on debt servicing

Chart 4: Level of indebtedness (household net indebtedness index)

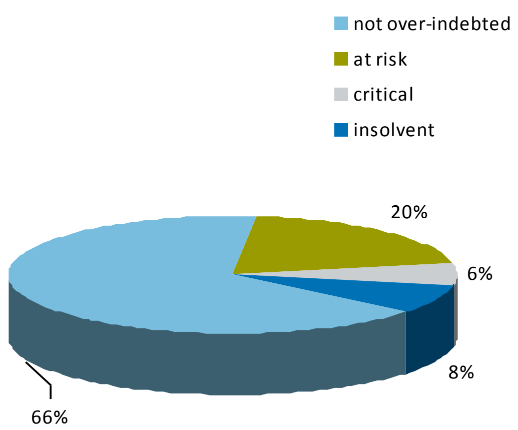
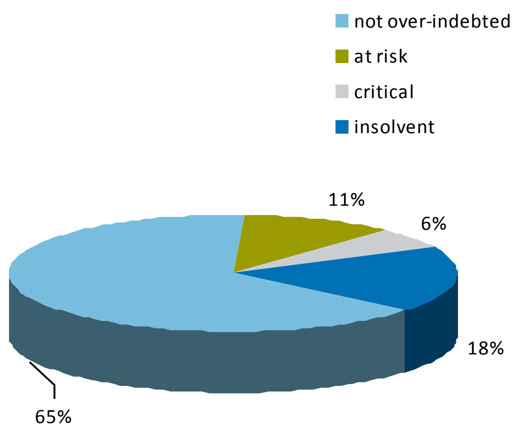


Chart 5: Level of indebtedness (business net indebtedness index)



Over one third of clients were seriously over-indebted, faced a critical situation or were at risk of becoming over-indebted. Depending on the type of indebtedness index calculated, the degree of over-indebtedness differed. The household indebtedness index indicated that of the clients who fell into the “at risk”, “critical” or “insolvent” groups (34% of the total), the majority (20% of the total) were at risk of becoming over-indebted, while the business indebtedness index showed the prevalence of insolvent borrowers (18% of the total) among the same groups (35% of the total).

Multiple borrowing and over-indebtedness went hand in hand. The level of indebtedness, measured either through the household or business net indebtedness index, increased with the number of active loan contracts (charts 6 and 7). While the incidence of over-indebtedness increased with only the second credit contract when measured through the household indebtedness index, higher indebtedness in the case of the business net indebtedness index was caused by three or more active credit contracts.

Chart 6: Multiple borrowing and over-indebtedness (household net indebtedness index)

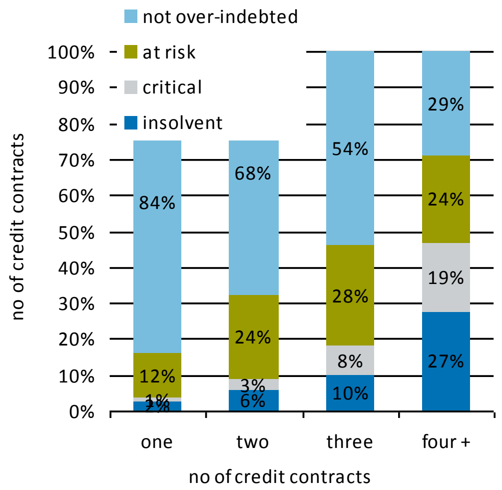
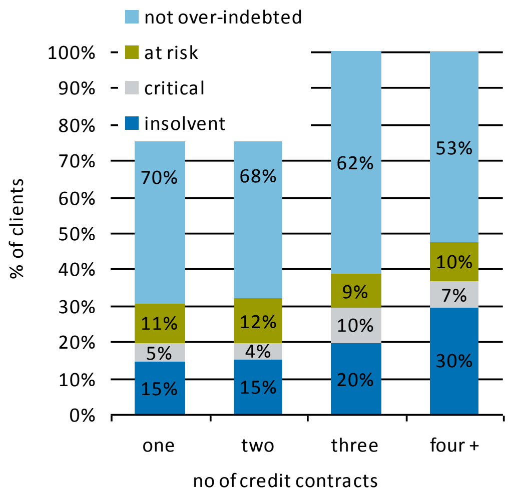
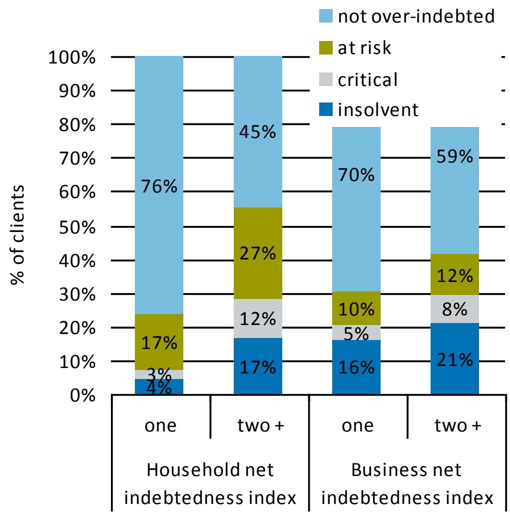


Chart 7: Multiple borrowing and over-indebtedness (business net indebtedness index)



Over-indebtedness was more often seen among clients who cross-borrowed from several different institutions. Engagement in credit contracts sourced from a number of different credit providers resulted in a higher incidence of insolvency, being in a critical situation or being at risk of over-indebtedness (chart 8).

Chart 8: Cross-borrowing and over-indebtedness (household and business net indebtedness indices)



Clients borrowing as physical persons were more often over-indebted than legal entities. Overall, individuals were found to be more often insolvent and at the risk of becoming over-indebted.

INDEBTEDNESS LEVEL AND REPAYMENT PERFORMANCE

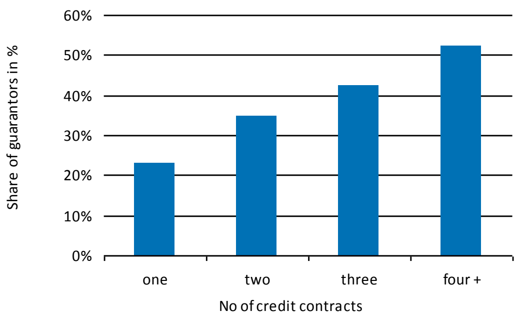
Repayment performance was not directly linked to the level of a client's indebtedness. There was no clear indication that borrowers with higher debt service in relation to their income were less timely with their repayments.

GUARANTEES AND CO-DEBTS

Over a third of borrowers were guarantors for others. Quite a significant number of clients (34%) acted as guarantors and were registered as such in the CRK database. Those who acted as co-debtors (12% of clients) were involved in monthly repayments, although the extent of this engagement is unknown. Altogether, a high proportion of clients (42%) were engaged in other borrowers' liabilities by acting as co-debtors and/or guarantors.

Taking multiple loans was correlated with providing guarantees for others. The more loans people took for themselves, the more guarantees they provided for others. Among clients with single loans, only 23% provided a guarantee for other people (chart 9). This rose to 53% among clients who had taken four or more loans for themselves. On average, guarantors provided 1.9 guarantees, with the maximum being 16.

Chart 9: Multiple borrowing and guaranteeing



Clients who guaranteed overdue contracts more often experienced repayment problems with their own loans. Of borrowers who guaranteed overdue loans, 30% were late for more than 30 days on their own repayments compared to only 5% of those who guaranteed timely contracts. This might be due the fact that these clients contributed to the repayment of guaranteed loans and were thus unable to meet their own debt obligations.

A similar relationship could be seen between the repayment performance of co-debts and own loans. Of borrowers whose co-debts were delinquent for more than 30 days, 44% were late in repaying their own loans. However, this was on a very small scale, as only 5% of all borrowers guaranteed overdue contracts and only 0.7% of borrowers were engaged in overdue co-debts.

PUTTING THE PIECES TOGETHER: MULTIPLE CORRELATION AND COMPLEX INTERDEPENDENCE

The relationship between repayment performance, the level of indebtedness and a number of other factors was complex. Repayment performance was correlated with specific borrowing patterns. For example, the number of credit contracts, the extent of cross-borrowing, the credit source and engagement in overdue co-debts and guarantees all played a role. Although higher indebtedness levels were not directly associated with more delays in loan repayment, several factors which affected the repayment performance, such as multiple and cross-borrowing also affected the indebtedness levels of households and businesses.

CONCLUDING REMARKS

Compared to the results from the first study on over-indebtedness conducted in Kosovo in 2011, the over-indebtedness situation in the MSE segment (with loans between EUR 10,001 to 50,000) is more serious than in the micro segment (with loans up to EUR 10,000). One third of borrowers in the MSE segment were seriously over-indebted, faced a critical situation or were at risk of becoming over-indebted, as compared to only one quarter of clients in the micro segment. This is not yet a crisis situation, but should be considered a warning sign and preventive measures should be undertaken to tackle the problem.

Overall, the results of the study show that there are few differences between the two MSE segments – Segment 1 with loan amounts ranging between EUR 10,001 – 25,000 and Segment 2 with loan amounts ranging between EUR 25,001 – 50,000. They are similar in terms of borrowing patterns and their indebtedness levels although they differ considerably in repayment performance.

RECOMMENDATIONS

Based on the results of the study, recommendations for key groups of industry stakeholders were developed and are set out below. While the results from the present study complement those from the first study and have allowed us to gain a more comprehensive picture of the incidence of over-indebtedness in the MSE finance market, some of the recommendations from the first assessment are still valid and have, therefore, been repeated here. Additional recommendations have been added where useful.

Recommendations for credit providers

1. Reduce multiple borrowing

The study confirmed that the number of credit engagements increases indebtedness levels and the risk of repayment default. Financial institutions should therefore be more careful in granting additional loans to clients who are already engaged in debt.

2. Reduce cross-borrowing from multiple institutions

Borrowing from different institutions is characteristic for over-indebted clients and those with repayment problems. Efforts should be made to reduce the number of institutions from which a client borrows at any one time. This can be achieved by setting limits not only on the number of credit engagements a client undertakes, but also the number of institutions from which a client borrows simultaneously. Such limits could be agreed upon in a sector-wide code of conduct that all credit providers should adhere to.

3. Limit guarantee participation of multiple borrowers

The results of the study show that guarantors often have high debt loads, so the defaults of some clients can stretch the repayment capacity of their guarantors and trigger a chain of repayment problems. Financial institutions should be more cautious in approving guarantors who are at the same time borrowers with their own debts.

4. Periodically update client information after loan disbursement

As many clients take consecutive loans, financial institutions should periodically check CRK data during the loan term in order to better assess the actual debt load and the risk of non-repayment of their borrowers.

5. Periodically update income data after loan disbursement

Financial institutions should also monitor changes in client income levels during the loan term, in order to be able to identify over-indebted clients or those at risk of becoming over-indebted. Such information, together with the CRK data, should be recorded in their MIS, which would allow credit providers to conduct their own indebtedness analysis.

6. Agree to report repayment amounts to CRK

Credit providers should be transparent about their pricing and the true cost of debt and, therefore, agree to report the monthly dues of their clients to CRK. This will allow for better assessment of client repayment capacity before the next loan disbursement and will also enable monitoring of that capacity throughout the loan term. As many clients take consecutive loans, financial institutions should be able to check the total debt service of their borrowers at any time during the loan term.

Recommendations for the Credit Registry of Kosovo/Central Bank of Kosovo

1. Collect information on monthly debt servicing

This recommendation was made in the first study on microcredit over-indebtedness in Kosovo, but has become even more important for the two market segments analysed in this project. Because of the high incidence of multiple borrowing, credit providers should have access to information about client debt service behaviour before making disbursement decisions. According to the latest news from CRK, this recommendation has been taken up and will be implemented, at least for banks, by the end of 2012.

2. Set-up a function specifically for the analysis of credit registry data

CRK or the analytical department of the Central Bank should analyse and publish statistics on the repayment performance of different types of credit users from the data collected by CRK. The analysis conducted during this study can serve as an example for further replication and should be "internalized" within CRK/CBK. Additionally, examples of reports published by credit bureaus in other countries could be used to design a set of publications to be produced periodically, based on credit registry data. The historical analysis of loan use and repayment performance would provide a better understanding of trends in the sector and be of benefit to it.

3. Publish more detailed information about the development of different segments of the credit market

No information on the credit segments analysed within the scope of this study is publicly available. While microcredit statistics are available from several sources (Association of MFIs – AMIK, MIXMarket platform), information about the number of borrowers in the MSE segment, credit volumes and the repayment performance of MSE clients is not disclosed anywhere. As a public body, CRK/CBK are best equipped to periodically release reports on developments in the credit sector, with statistics about outreach, the volume of credit and repayment performance. Cooperation in this regard could be sought with the Kosovo Bankers' Association (KBA), which is already engaged in the analysis of banking sector data.

4. Set-up a national debt advice centre

While the study results show that there is no acute over-indebtedness crisis in Kosovo, a fairly large percentage of MSE clients are over-indebted. CBK is encouraged in its current considerations to set up a national debt advice centre, which would provide counselling services to clients of banks and MFIs who are having difficulty servicing their debts. Such a centre could also provide financial literacy training and engage in awareness-raising campaigns. It could be attached to the Central Bank, to the Banking or Microfinance Association, or set up independently as a non-governmental organization. The role of banks and MFIs as members and their financial contributions to the centre should be clarified.

Recommendations for the Kosovo Bankers' Association and the Association of Microfinance Institutions in Kosovo

1. Promote transparency regarding credit operations

As previously pointed out, information on the number of borrowers in the MSE segment, credit volumes and the repayment performance of MSE clients is not disclosed anywhere. While KBA has recently started to publish a magazine through which it is creating more transparency and promoting financial literacy, it is recommended that it also undertakes analysis of sector statistics and publishes them in close coordination with the Central Bank. Overall, it is recommended that both associations collect and disseminate more detailed monthly statistics on developments in the credit market.

2. Facilitate the development of industry standards

KBA and AMIK could support the development of a set of standards, or code of conduct, that should be adhered to by all credit providers as a preventive measure. Such a set of minimum standards could, for example, set limits regarding the number of institutions from which a client can borrow at any one time.

Recommendations for donors/investors

1. Promote pricing transparency

In order to include repayment information in the CRK reporting, financial institutions should be encouraged to disclose their loan pricing. The results of the previous study in Kosovo showed that the reluctance to reveal this information was quite high among microcredit providers for competitive reasons.

2. Support CRK and CBK in setting up the analytical function

Donors and investors could play a role in helping to enhance the unit or function which would periodically analyse credit registry data and publish indicators of credit market development.

3. Support the Central Bank and/or sector institutions in setting up a debt advice centre

If the Central Bank and/or financial institutions set up a debt advice centre, donors and investors could play a role by advising on best practices in the field of financially sustainable debt advice services.

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