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The Effects of Consumer Lending and Consumer Loans on Microfinance Institutions

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Executive Summary

Problem Description and Objective Apart from loans to microentrepreneurs (*microcredit*) additional financial services, such as saving and insurance as well as loans for education, emergency or consumption are increasingly provided in the microfinance market. This report focuses on consumer loans in the microfinance market (*micro-consumer loans*) of Colombia, Bosnia and Herzegovina as well as Paraguay. Micro-consumer loans have been associated with repayment crises in the past. The most prominent example is Bolivia, where the provision of consumer loans to microentrepreneurs is partly blamed for the repayment crisis that hit in the late 1990s. The effect of micro-consumer loans on MFIs needs to be identified in order for risk to be properly assessed in the microfinance market. This is useful for regulators, investors and institutions active in the microfinance market. The hypothesis for this report is that micro-consumer loans decrease loan portfolio quality for MFIs active in the microfinance market of that country. How do micro-credits possibly have adverse effects on MFIs? To answer this, the micro-consumer loans and microcredit are compared. This identifies two main differences. First, they differ by the planned usage of the loan: Micro-consumer loans are used for the purchase of consumption goods for private (non-productive) use, for example a television. On the other side, microcredit is for productive purposes, such as the purchase of stock or tools for the microenterprise. Second, they differ in the lending methodologies. The lending methodologies are mainly distinguished in the application procedure, assessment of repayment capacity and the reaction upon late payment. The reason for the varying lending methodologies is that the two loan types typically target different clients. Whereas microcredit is disbursed to microentrepreneurs, micro-consumer loans target employed clients. Thus, the two loan types differ in their repayment source and formality: Microcredits are repaid using proceeds from the informal microenterprise while micro-consumer loans are repaid by regular wage income from a formal employment. This difference in the main repayment source allows the repayment incentives for loans to salaried clients to deviate from the methodology applied for credits to microentrepreneurs.

Available literature suggests that micro-consumer loans are not only provided to salaried employees but also to microentrepreneurs. This provision of loans with an inadequate lending methodology has been associated with repayment crises of microfinance markets in the past.

Two main institution types providing micro-consumer loans are identified. (i) Microfinance institutions (MFIs) and (ii) traditional financial institutions. The latter are not specialized in the provision of loans in the microfinance market (non-microfinance specialized institutions, NMSIs) but are active in the formal banking sector. It is suggested that these NMSIs generally enter the microfinance market and provide loans to clients using the lending methodologies they also apply in the formal banking sector. On the other side, MFIs supply micro-consumer loans. It is noted in the literature that the MFIs adapt their lending methodologies in response to competition from NMSIs.

This report's aim is to identify if non-microfinance specialized lending methodologies are applied in the microfinance market due to the provision of micro-consumer loans, and if yes, how it affects existing MFIs. Multiple steps are carried out.

- Identification of the main institutions active in the micro-consumer loan markets
- Identification the micro-credit client
- Comparison of lending methodologies applied for the two loan types
- Comparison of risk for microcredits and micro-consumer loans
- Testing of the relationship between lending methodology and risk of the two loan types
- Testing if MFIs adapt lending methodologies as response to the involvement of traditional financial institutions in the microcredit market

Methodology The methodology of this report is divided into three parts. First, the microfinance and consumer loan markets in Colombia, Bosnia and Herzegovina as well as Paraguay are analyzed using country specific data. Both, NMSIs and MFIs are included. Second, to obtain information on the micro-consumer loan market primary data is collected with a questionnaire. This part includes both MFIs and traditional financial institutions. Third, secondary data is analyzed using panel data techniques. This only includes data on MFIs. The mix of quantitative and qualitative methodologies applied in the three parts are now described in more detail.

Data from regulators and associations are used to describe the development of the consumer loan market in the three countries. The microfinance market is analyzed using data from regulators, associations and the MIX Market. The analysis is mainly complicated by ambiguous definitions and restrictions on data availability.

Due to lack of publicly available data, information on micro-consumer loans is collected through a questionnaire. The objective is to gather information on target clients, lending methodologies and risk of micro-consumer loans. The questionnaire is sent to (i) MFIs in Colombia, Bosnia and Herzegovina as well as Paraguay and (ii) institutions in the solidarity sector (mainly cooperatives) in Colombia. This allows to obtain valuable insight into differences between traditional financial institutions and MFIs institutions. There are 80 valid replies of which 68 are from the solidarity sector in Colombia.

To estimate a possible relationship between loan portfolio performance and the provision of micro-consumer loans panel data analyses are carried out. Data reported by MFIs to the MIX Market for 2008 and 2009 is used for the analyses. Not all variables that possibly affect loan portfolio performance may be identified and are available for the inclusion in the analysis. To control for unobserved variables two different approaches are applied: a difference-in-differences estimation and a fixed-effects model. For the difference-in-differences estimation the sample is divided into two groups, the treatment and control group. The treatment is defined as consumer loans. The treatment group thus consists of MFIs offering consumer loans and MFIs that do not offer consumer loans are in the control group. The average changes of the dependent variable before and after the introduction of consumer loans are then compared. An alternative method to control for unobserved variables is the fixed-effect regression model. The main idea of this model is to include a fixed effect variable in the regressions for each year that captures all independent variables that do not change over time. The fixed-effect variable is removed by differencing the equations for the two years. The resulting *time-demeaned* equation is then estimated using pooled ordinary least square regression.

Findings A word on data availability: Micro-consumer loans are disbursed by MFIs and NMSIs in the three countries. It is not possible to identify the micro-consumer loan portfolio of NMSIs While information on consumer loans is available for MFIs since 2008, NMSIs do not identify the consumer loan portfolio dedicated to the microfinance market. Apart from the lack of data, nonuniform definitions of the traditional and the microfinance market complicate a classification of the two loan types. Additionally, it is suggested that definitions of regulators are not consistently followed, as for example observed in Colombia.

The analysis of country specific data on consumer loan and microfinance market identified three major interdependent factors influencing the micro-consumer loan market: the formation of the microfinance market, the state of the consumer loan market as well as the extend and nature of competition in microfinance market. The formation of the microfinance market and the competition in the microfinance market mainly influence lending methodologies applied in the microfinance and the micro-consumer loan segment. On the other side, the state of the consumer loan market may directly or indirectly provide incentives for institutions to enter the micro-consumer loan market. Further analysis is needed to describe the effects of these three identified aspects for a broader dataset.

Results from the questionnaire provide insights into lending methodologies and micro-consumer loans as well as institutions active in the micro-consumer loan market. An overview of the existing literature suggests that micro-consumer loans are related to a shift of lending methodologies away from microfinance specific ones. The questionnaire identifies that in general different application procedures and loan terms are applied for micro-consumer loans and microcredit. However, the type of difference is not identified. Replies from the questionnaire confirm that the entire microfinance market is affected by the provision of micro-consumer loans. Regardless of offering micro-consumer loans, MFIs are mainly impacted by the provision of consumer loans by banks, MFIs, consumer lenders and consumer retail lenders. Especially the role of consumer retail lender merits closer attention: these institutions are close to the household and the loans may also be used for productive purposes. However, as retail lending is not regulated in most countries, data availability is severely limited. The most noted effect is the adaption of consumer lender methodology and that clients start to borrow simultaneously, this is however not representative.

Two statements about risk associated with the two loan types may be made with the findings of the questionnaire. Consumer loans are not generally considered more or less risky than microcredits. Also, there is a weak statistical relationship of application procedure and risk of micro-consumer loans and microcredits from the questionnaire sample.

The fixed-effect regression shows small negative statistically significant relationships between risk (sum of PAR 30 and write-off ratio) and micro-consumer loans as well as PAR 30 and micro-consumer loans. Thus, for the sample of the three countries for 2008 and 2009, more micro-consumer loans decreased risk for MFIs. The hypothesis that micro-consumer loans have an adverse effect on MFIs is thus rejected. The results are, however, to be considered with caution. The limited data availability constrain the use of statistical models and the control for model misspecification.