The Risk of Over-indebtedness of Microcredit Clients in Azerbaijan

Results from a comprehensive field study

Justyna Pytkowska, Microfinance Centre (MFC)
Sylvia Spannuth, Finance in Motion

OBJECTIVES OF THE STUDY

Following the studies conducted in Bosnia and Herzegovina and Kosovo,[1] the European Fund for Southeast Europe (EFSE) commissioned a study to assess whether there is a problem of (over)indebtedness among microcredit clients in Azerbaijan.

The topic is also of relevance to the Fund's partner countries in the European Eastern Neighbourhood Region. More specifically, in the face of a growing microfinance sector and inflow of funding, industry stakeholders have voiced concern that the increasing indebtedness of microcredit clients has become a growing problem in the country. The study was therefore implemented with the objectives of (i) gaining an understanding of the level of indebtedness and underlying borrowing patterns of microcredit clients, (ii) identifying factors on both the demand and supply side which have led to or prevented over-indebtedness and (iii) providing recommendations on how to address and prevent over-indebtedness in the country.

METHODOLOGY

Sample. The analysis is based on a sample of 1,100 microcredit borrowers of eight microcredit providers (six leading microfinance institutions (MFIs) and two banks). The sample was drawn up proportionally, reflecting each institution's share of the microcredit[2] market. Given the scale of outreach of the participating institutions, the results represent 82% of the microcredit market in terms of the number of borrowers.

The sample was drawn up through two different methods: (i) random sampling from the MIS database of active clients of seven participating institutions and (ii) non-random sampling among clients coming into the branches of one financial institution.[3]

Approach in three stages. The study was conducted between May 2011 and April 2012 in three stages. In the first stage, a comparative analysis of the results of the Azerbaijan Micro-Finance Association (AMFA) self-test on cross-indebtedness was conducted.[4] In the second stage, quantitative research was conducted, during which

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

[2] Microcredit was defined as a credit contract for business purposes not exceeding US$ 20,000 or for agricultural activities not exceeding US$ 10,000 at disbursement.

[3] Owing to confidentiality concerns, one institution refused to provide a sample of clients from their MIS and share credit data and client contacts. Hence, 30% of the clients in the sample were selected by non-random sampling.

[4] Between May 2011 and May 2012, AMFA conducted a 'self-test' among its members in three regions. The objective of the test was to assess the level of cross-indebtedness. The participating member institutions provided the names of their active clients in those regions and AMFA cross-checked to see whether those clients had also taken loans from other AMFA members. All clients of the participating financial institutions were included in the analysis, regardless of loan size. As part of the study, MFC conducted a comparative analysis of the main findings of the test.

survey data was collected from 944 clients and supplemented with MIS data from seven out of eight participating institutions. The analysis resulted in a fair picture of the borrowing patterns and the (over)indebtedness of the clients in the sample, based on self-reported information.

In the third stage of the study, supply-side factors influencing indebtedness levels were identified. For this purpose, interviews were conducted with 24 credit managers, branch managers and loan officers of the participating institutions.

Data limitations. The assessment faced significant shortcomings in terms of data availability and reliability, as the analysis was based on data collected through a client survey only, i.e. information self-reported by clients. Unlike the studies conducted in Bosnia and Herzegovina and Kosovo, data from the public credit registry could not be used to assess the incidence of over-indebtedness and cross-indebtedness in the country. Discussions with financial sector stakeholders upon completion of the study revealed that the figures presented are likely to underestimate the incidence of over-indebtedness. The results from the study should therefore be treated with caution.

RESULTS OF THE AZERBAIJAN MICRO-FINANCE ASSOCIATION SELF-TEST

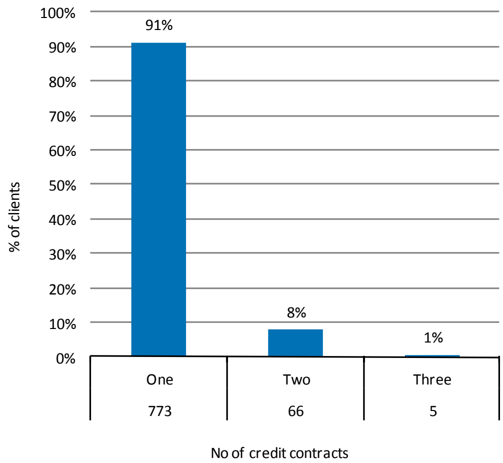
High levels of cross-borrowing prevail in certain regions. The comparative analysis of the results of the self-test conducted in three regions revealed that cross-borrowing is most common in Sheki region, where 25% of microcredit borrowers had active loans from more than one financial institution. The percentage of cross-borrowing clients in the other two regions was much lower – 11.2% in Ganja and 9.1% in Lankaran.[5] In the majority of cases, clients borrowed only from two institutions, with almost none being clients of more than four financial institutions.

High levels of cross-indebtedness in Sheki region point to the threat of over-indebtedness there, especially as it affects clients of most of the institutions. More than 20% of the borrowers of each of 9 out of the 11 institutions participating in the self-test were clients of at least 2 institutions. In all three regions, most of the credit providers had overlapping clients with the largest financial institutions in the respective region, which thus appear to be the competitors for all the other credit providers operating there.

BORROWING PATTERNS

The scope of multiple borrowing is low. The results showed that 8.4% of respondents were repaying more than one loan at the time of the survey. Adding in the loans of all household members showed that 13% of households had multiple loans. On average, clients had 1.1 active loans. Only 5.4% of clients admitted that other household members had active loans too, leading to an average of 1.2 active loans per household, with a maximum of 5.

Chart 1: Multiple borrowings

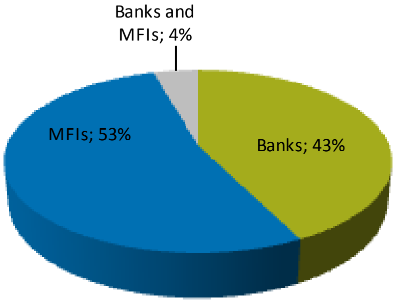


[5] One of the major microcredit providers did not participate in the self-test in Ganja and Lankaran. It can therefore be reasonably assumed that the extent of cross-borrowing is actually higher in those two regions.

Clients sometimes apply simultaneously for several loans. Respondents indicated that they make multiple loan applications in order to receive several loans and thus increase the amount of debt. Thirteen per cent of borrowers indicated that they applied for a loan in several institutions at the same time. More than half of them (65%) received loan approval from more than one institution and, in most cases, took all the granted loans they had been offered.

Cross-borrowing from different types of institutions is relatively rare. As the majority of borrowers are repaying just one loan, the level of cross-borrowing is relatively low. As a result, only 4% of all microcredit borrowers were simultaneously clients of banks and MFIs (chart 2). However, when the sub-sample of clients with multiple loans was analysed, it became clear that as many as 51% borrow concurrently from both types of institutions. This indicates a strong overlap and integration of the microcredit and banking sectors.

Chart 2: Source of credit (% of clients)



REPAYMENT PERFORMANCE

The results of the survey reflect good repayment discipline among microcredit clients. As few as 1.1% of respondents stated that they were late with loan repayments at the time of the survey. However, cross-checks with the MIS data from the financial institutions for a sub-sample of borrowers revealed that 2.9% of clients were late with their repayments.[6]

Guaranteeing for other borrowers was moderate. According to the survey results, 36% of borrowers were guarantors for other borrowers. As over a quarter of borrowers were engaged in group lending, the extent of providing guarantees for others can be considered to be moderate. Guarantors were more often seen among MFI clients, who also provided guarantees for a larger number of people. There was no correlation between the role of a guarantor and over-indebtedness.

OVER-INDEBTEDNESS

Definition. The level of indebtedness was assessed using two measures: (i) an objective measure of the amount of debt service in relation to net income (net indebtedness index) and (ii) a subjective measure of the perception of debt burden.

Objective measure. A net indebtedness index was calculated using the following formula: *'total monthly instalments on household debt'* divided by *'net monthly household income'*.[7] Based on the calculation of the net indebtedness index, clients were classified into four groups:

- *Insolvent* – if the client spent all the net income of the household on debt servicing, the net indebtedness index was equal to or exceeded 100%
- *Critical* - if the client spent between 75% and 100% of the household net income on debt

[6] As one participating financial institution did not provide MIS data for their clients, cross-checks were conducted for a sub-sample of 618 respondents. The survey results were not consistent with the MIS data, as (i) clients might have repaid their overdue loans between July 2011 and the time of the survey (November 2011), (ii) the loans might have been written off or (iii) clients simply did not admit the repayment delays.

[7] Net monthly household income = total monthly gross income of the household minus total monthly expenses of the household

servicing, the net indebtedness index was between 75% and 100%

- *At risk of over-indebtedness* – if the client spent between 50% and 75% of the household net income on debt servicing, the net indebtedness index was between 50% and 75%
- *Not over-indebted* – if the client spent less than 50% of the household net income on debt servicing, the net indebtedness index was below 50%.

Within the scope of the study, two versions of the indebtedness index were calculated:[8]

- Net indebtedness index of the individual, i.e. monthly repayments of the borrower/net monthly household income
- Net indebtedness index of the household, i.e. the sum of monthly repayments of all household members/net monthly household income.

Measuring the indebtedness level was a challenge, as calculations using data from different sources brought different results. Generally, the survey results indicate a much higher number of over-indebted, i.e. insolvent, borrowers than the MIS data of the financial institutions. The figures show that between 26% (MIS data) and 43% (survey data) of the clients are, in summary, at risk of becoming over-indebted, face a critical situation or are already insolvent.

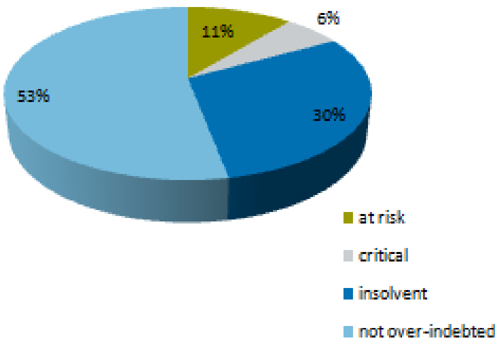
[8] The individual net indebtedness index was calculated using the available data from the MIS of four institutions and from the survey data, while the household net indebtedness index was calculated based on the survey data only.

Table 1: Distribution of borrowers of the sub-sample by net indebtedness index of the individual calculated from two data sources

	% Clients	
	Calculation from MIS data	Calculation from survey data
Not over-indebted	74	57
At risk	17	9
Critical	6	7
Insolvent	3	27
Total	**100**	**100**

Puzzling results were obtained from the comparison between survey and MIS results of the individual indebtedness index. For a sub-sample of 523 clients for whom data from the two sources was available, the individual indebtedness index was calculated. A comparison of the results (table 1) clearly shows that the share of over-indebted clients is much higher when using the survey data for calculations. Possible explanations could include (i) the time lag between the disbursement date and the time of the survey, (ii) under-reporting of income by respondents at the time of the survey or (iii) over-reporting of income by respondents at the time of the loan application.

Chart 3: Level of indebtedness (net indebtedness index of the household)

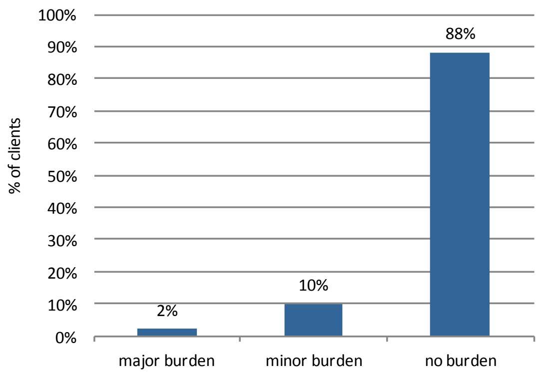


Thirty per cent of microcredit households are seriously over-indebted, spending all their disposable income on debt repayment. According to the survey results, only just over 50% of households are not over-indebted, while 7% are at risk of becoming over-indebted, spending over 50% of their net household income on debt servicing every month, and 11% face a critical situation (chart 3), as the amount spent on debt servicing every month exceeds three quarters of whatever money is left in the household after meeting all necessary expenses.

Subjective measure. The perception of debt burden was assessed by asking clients to state to what extent debt repayment had been a burden on their household finances.

Only 12% of clients admitted that repaying loans places a burden on their household's finance. However, the majority of them felt only a minor burden (chart 4).

Chart 4: Level of indebtedness (subjective measure)



DEMAND-SIDE FACTORS THAT INFLUENCE THE LEVEL OF INDEBTEDNESS

The study identified a number of factors that correlate with the degree of indebtedness.

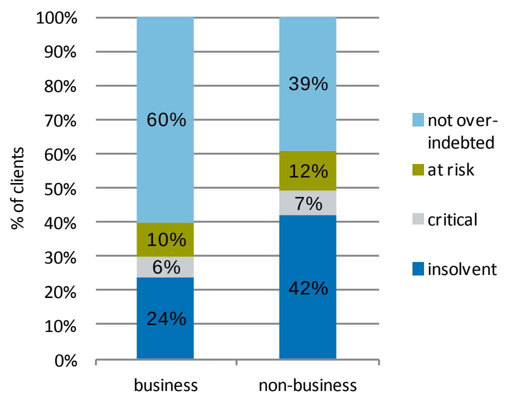
Multiple borrowing and over-indebtedness go hand in hand. The level of indebtedness[9] increases with the number of active loan contracts. Among clients with a single loan, only 28% are insolvent compared to 43% of those who have two or more loans. Also, the proportion of clients facing a critical situation and those at risk increases significantly with the number of loans (chart 5).

Chart 5: Multiple borrowing and over-indebtedness

Higher loan amounts and larger monthly repayments are characteristic for those who are over-indebted. Borrowers who were insolvent, facing a critical situation or at risk of over-indebtedness, had on average taken out loans 25% larger than those clients who were not over-indebted (US$ 3,092 versus US$ 2,419).

Over-indebtedness is more often seen among clients with non-business loans for consumption and housing needs. Clients with loans for household goods, personal items and home improvement were more often found to be insolvent (chart 6).

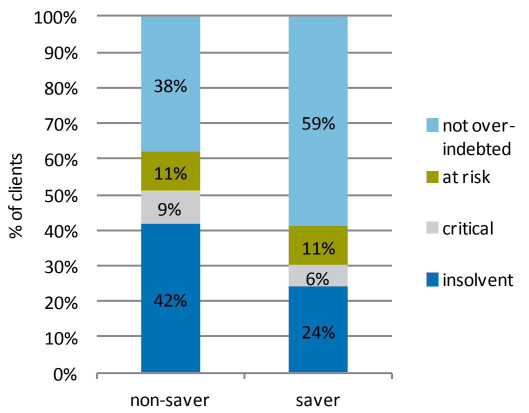
Chart 6: Loan purpose and over-indebtedness



[9] Calculations based on the net indebtedness index of the household.

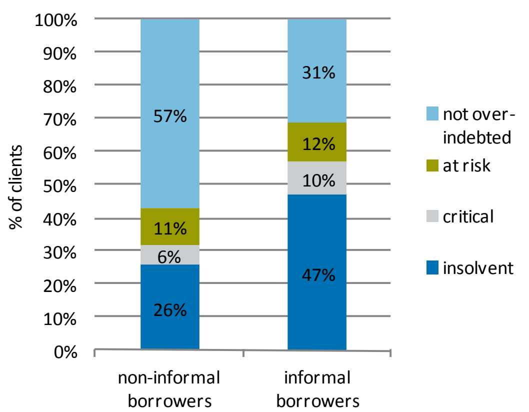
Over-indebted clients do not save. As many as 62% of non-savers were over-indebted or insolvent, in a critical situation or at risk of becoming over-indebted. The incidence of over-indebtedness was much lower among savers: 41% of savers were over-indebted. In particular, the difference was strong in the incidence of insolvency (chart 7). Insolvency was also correlated with the lack of savings accumulated for "rainy days".

Chart 7: Saving and over-indebtedness



Over-indebted clients more often borrow from informal sources. Informal borrowers were more often found among the insolvent or those in a critical situation (chart 8).

Chart 8: Informal borrowing and over-indebtedness



Low-income clients and those whose financial situation had deteriorated in the last year were more often insolvent or in a critical situation. Households with frequent money shortages for food, fuel and medicine were more often among the insolvent households.

Over-indebtedness was more frequent in certain geographic areas. According to the survey results, Lankaran region was the most populated with over-indebted borrowers, followed by Baku. When comparing the distribution of over-indebted borrowers across different areas of residence, the capital Baku also stood out significantly in the incidence of over-indebtedness in comparison to other urban and rural areas.

Additionally, certain psychological and sociological features were characteristic for over-indebted borrowers. These included:

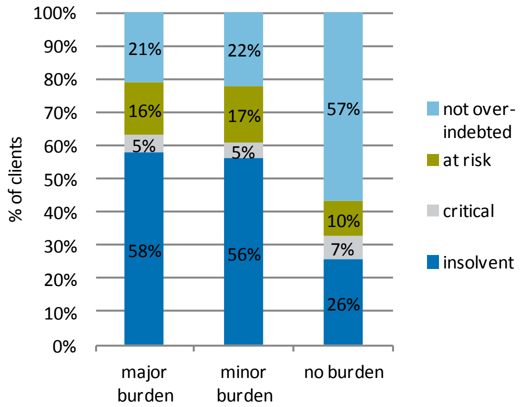
- <u>Psychological characteristics:</u> "judgement error", an under-confidence bias representing the fatalistic belief in a higher likelihood of negative events affecting the person

- <u>Sociological characteristics:</u> lack of economic socialization in childhood and a low level of social comparison

Factors influencing the debt burden. Respondents attributed the burden of debt mainly to a difficult financial situation due to low income, the high cost of living or unexpectedly large expenses. For the vast majority, these negative changes had happened only recently.
Those who did not feel the debt burden at all attributed it chiefly to their own abilities – good money management or wise borrowing.

The perception of debt burden went together with a high indebtedness index. People with a higher indebtedness index were more often among those complaining about the debt burden (major or minor). In particular, people who perceived their debt as burdensome were twice as likely to be insolvent as those feeling no debt burden at all (chart 9).

Chart 9: Over-indebtedness (objective and subjective measure)



SUPPLY-SIDE FACTORS THAT INFLUENCE THE LEVEL OF INDEBTEDNESS

Factors which were found to cause or contribute to over-indebtedness in the other over-indebtedness studies were examined to see to what extent they are present in Azerbaijan. Additionally, interviews with the representatives of the financial institutions participating in the study gathered opinions about possible future developments and the potential threat of their negative impact on over-indebtedness levels in Azerbaijan.

The following supply-side factors affecting over-indebtedness were analysed:

- Loan portfolio growth
- Competition and market conduct
- Lending procedures
- Capital inflows and the role of microfinance investors
- Regulations
- Credit information sharing systems.

Loan portfolio growth has been moderate for the last few years and competition has not been fierce, but it is picking up and all institutions interviewed had something to say about the behaviour of the other market participants. As for lending procedures, several institutions appear to apply prudent measures in handling their clients. However, all have some doubts about the policies and conduct of other organizations. Concerns were raised regarding the “free ride” of some institutions undertaking little or no analysis of a client’s ability to repay a loan if a client already had a loan with a reputable lender, as well as the generally low quality of assessment of the repayment/debt capacity of borrowers. According to respondents, no aggressive marketing techniques are used to attract new clients. In addition, there is no evidence that capital inflows have been excessive or that they have contributed to the over-indebtedness of clients.

Until August 2011, non-bank MFIs did not provide credit information to the Centralized Credit Registry. Therefore, no credit provider (bank or non-bank) had access to a reliable source of information on the level of client debt. Only informal information-sharing mechanisms were used in the loan underwriting process. Although the effectiveness of these mechanisms was assessed as very good by the majority of the financial institutions interviewed, they do not stand comparison with the depth and reliability of information available from the credit registry.

At the time of the study, usage of credit registry data was still low but some institutions which had conducted a series of client checks were surprised and worried to see quite a large degree of multiple borrowing. This further proves that the information-sharing systems used instead of credit registry data do not provide sufficient information to financial institutions about the debt engagement of clients or potential clients.

RECOMMENDATIONS

The results of the research among microcredit clients and microcredit providers showed mixed results including first worrying signs of over-indebtedness in Azerbaijan. The participating institutions stated that the incidence of over-indebtedness and cross-indebtedness is thought to be much higher than the survey results suggest.[10] There is a general sense in the sector that indebtedness is a problem on the rise and that signs of concern should be taken very seriously and preventive actions should be taken.

The following are specific recommendations for different market participants in relation to over-indebtedness:

Financial sector

Over-indebtedness watch

While there may be no imminent credit crash and there are still growth opportunities in the credit market, putting in place an effective 'indebtedness watch', a joint effort to address the current situation in the market and develop preventive measures to address the problem, is advisable.

The indebtedness watch could be organized as a collaborative effort by key players for whom indebtedness is critically important. An indebtedness watch committee could be composed of the representatives of AMFA (microfinance), the Banks Association (banking), the Centralized Credit Registry (information-sharing), the consumer protection agency (Central Bank), the National Statistics Agency and the Central Bank (data on financial institutions and households), in addition to independent organizations as needed. The committee could meet quarterly to review the credit expansion and indebtedness situation in the country, recommend research to complement the available data and issue periodic reports that would include updates on the overall development of the credit market and potentially some specific indices related to over-indebtedness in the country. To give the committee credibility and weight, it should be chaired by a recognized professional authority (such as, e.g., the former Governor of the Central Bank).

Microcredit providers

1. Improve the implementation of responsible lending practices

Although the results of the study did not reveal any widespread misconduct in financial institutions, in fact the quality of assessment of client debt absorption and repayment capacity is often weak because of the low quality of information (self-reported by the client and verified only through informal information exchange) or by a deliberate relaxation of credit underwriting standards for efficiency gains.

It is, therefore, strongly recommended that the quality of the assessment of borrowers' repayment/debt capacity will be improved and the responsibility for providing appropriate credit products taken more seriously by financial institutions.

2. Use data from the credit registry for underwriting

Currently, with all banks and the majority of MFIs reporting to it and with data available in real time, the credit registry database appears to be the most reliable source of information on client debt levels.

It is strongly recommended that credit providers integrate credit registry checks with their loan

[10] Discussions with the participating financial institutions following the study revealed that recent credit registry checks of new loan applicants point to much higher levels of multiple and cross–borrowing.

underwriting process. Those checks should be mandatory while the integrity, technical capacity and functionality of the credit registry to allow for timely information sharing and analysis needs to be ensured. In order to overcome the cost barrier, microcredit providers should review their loan pricing and, for instance, include the price of the credit check in the loan fee. They should also continue the dialogue with the credit registry to agree on the best cost-benefit option.

3. Engage in financial education for clients

Most financial institutions participating in the study shared the same low opinion of the financial capabilities of their clients. However, no institution was engaged in any financial education activities. It is, therefore, recommended that credit providers offer their clients access to financial education programmes and adequately inform clients about the financial products and conditions which are offered by them.

Different models of financial education delivery have been tested in microfinance, in which financial institutions are either directly involved as education providers, delivering financial literacy trainings, or indirectly by referring clients to participate in programmes delivered by non-financial institutions. Both or either of these methods could usefully be deployed in Azerbaijan.

Association of Microfinance Institutions (AMFA)

1. Facilitate the setting up of a working group on over-indebtedness and strengthen its activities

AMFA has already facilitated the dialogue on over-indebtedness among its members, initiated a self-test research project on cross-borrowing and engaged its members in a discussion on the prevention of over-indebtedness. The natural continuation of this work would be to take a lead in creating an indebtedness watch agenda and organizing the work of an indebtedness watch committee along the lines set out in the recommendations above.

While the indebtedness watch group monitors developments in the credit market, the second track of activities facilitated by AMFA would include working with its members to implement measures for tackling and preventing over-indebtedness with concrete measures.

2. Facilitate the development of industry standards

AMFA is well positioned to continue facilitating the discussions of its members on a set of standards – code of conduct – that, for the benefit of both clients and institutions, should be adhered to by credit providers. Such a set of minimum standards will not only contribute to a large extent to prevention of over-indebtedness and improvement in the impact of microfinance, but will also allow financial institutions to maintain sustainable growth.

3. Facilitate the delivery of financial literacy to borrowers

The Association could work with its members to develop one or more financial education delivery models.

In the direct model, financial institutions could organize training sessions for their clients, or provide short counselling sessions and could also distribute printed materials. AMFA could facilitate the development of training modules and educational materials and organize the transfer of knowledge and expertise.

In the indirect model, AMFA could set up a training/counselling function to provide financial education for the clients of all credit providers. Such a function could be managed by the association or be an independent entity.

4. Promote good money management among borrowers

Separately from the financial education activities provided by financial institutions, AMFA could engage in the promotion of good money management practices through mass information campaigns and awareness-raising events.

Credit registry

1. Revise the current business model

In order to enhance the use of credit registry data for the assessment of client repayment capacity, the credit registry should consider diversification of its revenue sources and reduce the costs of client checks. This could be achieved by developing new types of fee-based products for financial institutions and other industry stakeholders.

Products for financial institutions could include:

- Client monitoring: tracking new credit disbursements and alerting the financial institution concerned if a client takes a new loan from another institution

- Institutional reports: producing summary reports for each institution about their clients, especially about the scale of multiple and cross-borrowing.

Products for other stakeholders could include:

- Reports for investors: tracking the credit activities of selected financial institutions (investment recipients).

2. Develop incentives for broader usage of credit information

As the most common reason given for not using credit registry data was price, the credit registry should offer incentives for financial institutions, such as discounts for larger volumes of checks or price packages for a fixed number of monthly checks.

3. Publicly disclose main statistics about credit activities

As a public body, the credit registry should extend its public function and periodically release reports on developments in the credit sector, with statistics about outreach, volume of credit and repayment performance. At the moment, the credit registry periodically conducts data analysis, but keeps the results confidential.

4. Improve the capacity of the database to process a large number of inquiries

One of the many reasons why credit registry data is not regularly used in the loan underwriting process is that it is often difficult to access the credit registry database, due to its limited capacity to process multiple inquiries. It is, therefore, recommended that the system be upgraded to improve the processing time for inquiries.

Investors

1. Endorse industry initiatives that facilitate responsible business practices

Investors should endorse and participate in initiatives that promote international best-practice standards and norms for responsible business practices, such as the UN Principles for Responsible Investment (PRI) and SMART Campaign. Along those frameworks, investors should promote responsible finance practices among their investees, including measures and initiatives to address the problem of microcredit client over-indebtedness.

2. Provide incentives for financial institutions to use credit registry data

Investors can play an important role in motivating financial institutions to check client records in the credit registry. There could either be a stipulation for this in the loan contract, or an incentive in the form of preferential treatment (lower interest rates or fees).

3. Provide incentives for responsible finance among financial institutions

Investors can also play a role in safeguarding adherence to the principles of responsible lending by credit providers. This is particularly important in view of the fact that the market is becoming more competitive and financial institutions may be more focused on short-term commercial goals rather than on long-term social responsibility.

Such incentives could include preferential loan conditions for investees who, for example:

- Endorsed the SMART Campaign's client protection principles (CPP) and utilize its tools available that help to turn those principles into action.
- Offer products with features which are appropriate for the institution's target clients
- Have a debt threshold is in place: for example, monthly instalments cannot exceed 50% of disposable net income
- Terms and conditions are easy for clients to understand (including extraordinary risks such as FX risks)
- An appropriate policy is in place that regulates multi-borrowing
- Have written rules regarding acceptable and unacceptable collection practices
- Conduct staff training on effective communication with clients
- Have staff incentive systems which value portfolio quality
- Make a net profit that does not exceed a certain level

4. Support initiatives promoting financial literacy

In order to facilitate the engagement of financial institutions in educating their clients, investors could provide some financial support for start-up activities. Depending on the choice of delivery model, such support could be committed to the development of educational materials, training curricula, setting up a training function, etc.

Donors

1. Support setting up adequate regulations and capacities that provide a better operating environment for the credit registry and better client protection

Currently only banks and non-bank credit organizations are mandated by the regulations to report to the credit registry, while credit unions and leasing companies are not. For the sake of completeness of the credit information available at the registry, appropriate legislation for these two types of institutions should be supported.

2. Promote overall awareness-raising for avoiding over-indebtedness at all levels of the sector

Donors should engage in promoting good practices which prevent over-indebtedness, especially those which have been successfully tested and implemented in other countries.

3. Invest in further research at the country level

Based on the findings of this study, the following research topics could usefully be pursued in Azerbaijan:

- An interesting observation was the fact that average loan amounts are fairly low (about USD 3,470) and loan maturities are strikingly short. A better understanding of the reasons behind this, through assessing the nature of typical demand patterns for micro business loans under the headline "quality of finance" would provide important insights.

- A study of the impact of a new market entrant, which is likely to change the nature of competition and credit underwriting in the country. This is a unique case that should be watched carefully and could provide insights into the development of a potential credit crisis in a dynamic setting

CONTACT

EFSE Development Facility
Sylvia Spannuth
at Finance in Motion, Frankfurt, Germany,
s.spannuth@finance-in-motion.com
Finance in Motion is the Fund Advisor to the European Fund for Southeast Europe (EFSE)