

# MicroSave India Focus Note 33

## Why Do Microfinance Clients Take Multiple Loans?

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February 2010

### Introduction

Since 2004 microfinance in India has gained impetus, and the sector has grown very rapidly. This trend was reinforced by the commercialisation of the sector, which is often characterised by increased competition for clients and a clear objective to seek profitability – resulting in more than one microfinance provider (MFI) operating in an area. While this offers members a scope to borrow from multiple sources, it can also lead them to over-indebtedness.

The aim of this note is (a) to understand and present the rationale and impact for multiple borrowings from a client perspective; and (b) to discuss how the MFI and its leaders perceive the issue and its implications. The observations and findings of the authors are based on extensive interactions and conversations with borrowers, MFI staff and leaders in the field.

The *State of the Sector Report, 2008* estimates the extent of multiple borrowing as prevalent in 10% to 20% of MFI clients.<sup>1</sup> However, actual incidence may be much higher, especially in mature markets or in markets where there are many MFIs competing for clients in the same area, such as the southern states of Andhra Pradesh, Karnataka and Tamil Nadu.

### Clients borrow multiple loans from:

- Moneylenders
  - Registered - Pawn brokers, local finance
  - Unregistered - *Thakur, Seth, Patel*
- SHGs – internal corpus, bank linkage, etc.
- Several different MFIs
- Different branches of the same MFI through group and individual lending (IL) methodologies

Clients borrowing from different types of lenders to meet their diverse needs have created some concerns (see box for the scope of such borrowing). The problem is complicated by the limited capacity of MFIs to limit loan use to ‘productive’ purposes. Clients often use multiple loans for “non-productive” purposes, such as meeting emergency expenses or for another more viable or lucrative opportunity.<sup>2</sup> Multiple loans are commonly used

for emergencies (indeed emergencies are often a trigger, motivating clients to seek credit from other MFIs). If the clients receive funds at an inappropriate moment in their business cash flow cycle, they may also be tempted to divert them to other needs like education, festivals, consumption etc.

However, the real concern is with clients taking multiple loans from different MFIs who have similar products with rigid instalment schedules (unlike most informal/semi-formal loans for moneylenders, SHG groups etc. which provide the flexibility to help clients manage repayments). The chances of getting over indebted are high due to the inadequate control mechanisms in MFIs to prevent multiple lending.

### Views of a Senior Manager (of a Tier-II MFI) on Multiple Loans

*“Our field staffs are very aware of the number of loans each member has taken from different MFIs. But, they don’t reveal the information nor do they capture it in the loan documents as their incentives mainly depend on number of clients, outstanding and repayment percentage”.*

From the *client’s perspective* there are quite a number of reasons for taking multiple loans including:

- Receiving inadequate loans for business expansion as the loans are based on loan cycles rather than cash flow;
- Repayment of existing (high interest) loans with money lenders;
- Borrowing to meet other requirements such as marriage, funeral, construction of house, health, education etc;
- For starting another business by the member/spouse/children;
- On-lending (like money lenders) to neighbours/friends;
- Purchasing gold jewellery in order to create savings;
- Unexpected receipt of loans (while already in debt) from banks/ government;
- Repayment of existing loans with other MFIs/ SHGs.

<sup>2</sup> Srinivasan, N., “State of the Sector Report 2008”, Sage Publications, London, UK, 2009.

<sup>2</sup> See *MicroSave India Focus Note 7 “Are Loan Utilisation Checks Necessary”*

A study conducted at Ramanagaram<sup>3</sup> for three months period, shows that 19 of the 20 households involved in the study were indebted to more than 2 MFIs/SHGs; 10 households to more than 4 MFIs/SHGs; and 2 households to a total of 7 MFIs. One of the common reasons cited for multiple borrowings was the inadequate loan size. 10 of the 20 households were spending more on loan repayments than on food. An analysis conducted by GFSPL<sup>4</sup> in Kolar showed that 11% of the MFI clients have loan accounts with 2 or more MFIs, with 20% of total loan amount disbursed is to clients with accounts in multiple MFIs.

A recent study<sup>5</sup> on stress levels of *kendras* (centres) conducted at Grameen Koota suggested that over the years, the older *kendras* have learned to manage stress by adopting improved strategies. For example: hanging on as the member gradually pays off her loans; managing the delayed payments for the delinquent client; saving up amounts as small as Rs.10 per member per week to manage large delinquencies; starting group-based income generating activities that help them generate income and build affinity; adopting more rigorous member selection practices; checking loan utilisation even when it is not required; and not permitting members to join who are members of too many other MFIs.

From the *MFIs' perspective*, there are quite a number of potential ways for multiple borrowing to happen:

- MFIs' aggressive growth plans force poaching the existing clients of other MFIs as the members have proved their credit history and they have fair knowledge of joint liability group norms and credit discipline;
- Clients do not reveal their borrowings/membership with other providers (and also MFIs do not share the information with other MFIs);
- Loan sizes are based on cycle rather than cash flow;
- Different members from the same family or household take loans;
- Borrowers avail multiple loans by taking advantage of multiple spellings/names on multiple identity cards;
- Front line staff want to reach their monthly targets and thus ignore multiple borrowing;

- Front line staff do not reveal that the member has already taken multiple loans from different institutions as they do not get any incentives for revealing this information.

### Implications

When borrowers resort to multiple borrowings to smooth their cash flows, they must bear a heavy burden.<sup>6</sup> This includes: transaction, opportunity costs and time spent in various group meetings; household over indebtedness; stress of meeting multiple loan payment schedules; increased risk of inability to pay; stress of increasingly unstable joint liability agreements; and ultimately the risk of defaulting. For MFIs, there is a high risk of default and drop out, and a risk that staff and operational resources may be shifted to areas where a proliferation of MFIs is eroding portfolio quality.

### Conclusion

It is difficult to attribute such multiple borrowings just to unmet demand for credit from borrowers, or to dumping of loans by the MFIs on clients well versed with the MFI methodology.<sup>7</sup> However, MFIs can reduce the incidence of multiple borrowing. The appropriateness of disbursement timing can be improved through studying microenterprise cash flows by type, and changing operational policies to reduce mismatches between client cash flows and the timing of loan cycles.

Another strategy is to implement individual cash flow-based lending. This entails a special product design of which the terms and conditions are based on the actual needs of the clients' business; offer differential loan tenure and repayment schedules for each borrower based on cash flows; specialised recruiting, training and incentivising of a person only for cash flow analysis and develop specialised underwriting tools, analysis, process and approval.

At policy level, MFIs can: (a) initiate state level MFI-forums like Association of Karnataka Microfinance Institutions (AKMI) and share data about delinquent clients and areas of multiple loans; (b) also to adjust their field officers' targets to be more realistic, and (c) graduate clients with need and good credit history to individual lending with higher ticket size.

<sup>3</sup> Kamath, Rajalaxmi, Arnab Mukherji and Smita Ramanathan, "Ramanagaram Financial Diaries: Loan Repayments and Cash Patterns of the Urban Slums", IIMB Working Paper No. 268.

<sup>4</sup> Grameen Financial Services Private Ltd for the Association of Karnataka Microfinance Institutions (AKMI).

<sup>5</sup> Excerpts taken from the report 'The Voice of the Kendras: Diagnosing Internal Stress' a research conducted by teams of Grameen Koota and MicroSave in June and July 2009.

<sup>6</sup> Krishnaswamy, Karuna, "Competition and Multiple Borrowing in the Indian Microfinance Sector", IFMR-CMF Working Paper, September 2007.

<sup>7</sup> Srinivasan R. and Rajyalaxmi Kamath, "Microfinance in India: Small, Ostensibly Rigid and Safe", IIM-B Working Paper, 2009.