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REPAYMENT FREQUENCY AND DEFAULT IN MICROFINANCE: PRELIMINARY RESULTS FROM A PILOT STUDY IN WEST BENGAL

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BACKGROUND

It has been widely believed that frequent repayment is one of the most important premises, in addition to group lending, for successful micro-credit programs. To make on-time repayments at weekly meetings, borrowers must nurture a sense of thrift and acquire a habit of constant savings, and thus, financial discipline is gradually built within them. Group lending and weekly repayment form the backbone of the Grameen lending model, which is replicated across India. In the lack of collateral, financial discipline among poor borrowers is critical – at least it is so believed by lenders. Furthermore, weekly meetings provide an opportunity for group members (and loan officers) to check on how other members (or borrowers) are doing in their businesses or whether there is a sign of financial troubles. All of these factors eventually come down to reduced default rates.

These perceived benefits of frequent meetings, however, come only in return for large transaction costs for both borrowers and lenders. Sending loan officers to villages for weekly meetings takes up a major portion of MFI's operational costs. This gives pressures on their funds that can otherwise be used to reach more clients. This is as important from the borrowers' perspective, where attending weekly meetings entails opportunity costs – they can otherwise use the time for productive purposes.

Conventional economics claims the likelihood of default should not change irrespective of a borrower's repayment schedule, if the borrower is rational and is in a full information environment. However, microfinance practitioners generally agree that frequent repayment schedule helps to keep the default rate at the current level.

CMF undertook a study to test this belief and assessed the impact of introducing flexibility in repayment schedules on default rates, transaction costs for the MFI, and client behavior. Working with Village Welfare Society (VWS), a leading microfinance institution in Kolkata, West Bengal, the study team selected 100 joint liability groups consisting of 1,028 first time borrowers. Each group was then randomly assigned one of three different repayment schedules (number in parentheses indicates the number of groups in that group): For the first group the normal VWS repayment schedule of weekly repayment at a weekly meeting was assigned (30); for the second group monthly repayment at a monthly meeting was assigned (38); and for the third group, monthly repayment was assigned (32), but they were required to attend weekly meetings for the initial 3 months. Loan amount was uniform across all groups at Rs.4,000 to be repaid over 44 weeks. Since the repayment schedules were assigned randomly, any observed differences in default patterns across different groups can be attributed to the repayment pattern.

FINDINGS

We find no evidence that a less frequent repayment schedule increases either the likelihood of default or delinquency¹. We observed no default among the three groups during the study and delinquency rates remained low and similar across all groups (no statistical difference). This suggests that MFIs operating in similar settings as VWS can save significant amount of operational costs while maintaining default rates low by making repayment schedule less rigid². Table shown below provides the distribution of some measures of clients' repayment behavior. It does not indicate that there is a systematic behavioral difference across different groups. After controlling for other factors, such as socio-economic characteristics, group size, fixed effects for loan officers, etc., the differences in these figures are proved to be statistically insignificant. For detailed regression results, see Field and Pande, 2007³.

Group type	Late payment	Avg. days late
Weekly	1.4%	0.006%
Weekly meeting-Monthly repayment	2.9%	0.0034%
Monthly	0.8%	0.009%

This study result suggests that micro-credit providers can derive two big advantages from switching from weekly meetings and repayment schedule to a schedule at least as infrequent as fortnightly meetings and repayments. First, the per client loan management costs to the MFI can be greatly reduced by reducing loan officers' group meetings once every two weeks instead of once per week, and operations could be expanded as a result of a smaller loan officer work burden. Second, clients' borrowing costs have also been greatly reduced since they are required to attend less frequent meetings.

FUTURE RESEARCH

Future studies are necessary to build more on this evidence. Several caveats about this study should be noted. In particular, this study targeted a group of new borrowers in an urban area, 80 per cent of whom does not have any other sources of borrowing. In micro-credit, in the absence of collateral, the most important factor that deters borrowers from defaulting is denial of future loans. Availability of alternative credit sources is likely to change borrower's repayment behavior. In addition, the extent to which financial discipline affects borrower's repayment behavior may change depending on loan amounts. If this is the case, it requires more in-depth studies to find the threshold amount. Lastly, whether we would find similar results in rural settings remains uncertain. Future studies are called for to shed light on these issues.

¹ For the purpose of this analysis, three measures of delinquency were used: loans were considered delinquent when not repaid by 60, 56, and 54 weeks after loan disbursal.

² As noted in the "Future Research" section, whether this holds in rural settings needs to be tested.

³ Field, E. & Pande, R. (2007). Repayment frequency and default in microfinance: Evidence from India. CMF Working Paper Series, 20.