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Responsible Consumer Lending

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The Financial Access Initiative is a research center based at New York University, focused on finding answers to how financial sectors can better meet the needs of poor households.

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Early pioneers of the microfinance movement touted it as a vehicle to promote entrepreneurship and subsequently provide a pathway for poverty alleviation. However, financial diaries research such as that published in *Portfolios of the Poor*, shows us that microloans have multiple purposes beyond spurring small-scale enterprises. The poor have myriad expenses beyond their business endeavors such as health care costs, school fees, housing repairs, and unexpected emergencies. Consumer lending is one possible tool to help the poor cope with their (often unpredictable) consumption financing needs. However, it may not be the appropriate solution in all instances and also carries the risk of encouraging over-indebtedness and financing for "bad" consumption, such as to buy aspirational material goods.

The purpose of this brief is to provide a framework to guide financial institutions in their product design and client education decisions when they want to steer their clients towards better financial management. The appropriate consumer finance framework helps financial institutions design products that are optimized for a given financial need.

Housing

Housing has a number of features that set it apart from other consumer spending. Saving for an outright home purchase simply takes too long, while for those without their own home, rental costs absorb significant portion of income, making saving all the more difficult. Meanwhile, the absence of appropriate funding forces many poor families to resort to incremental building strategies, raising a house over a period of many years. This makes the half-completed property usable earlier, but the approach, especially when financed through savings, still misses years of potential household productivity benefits, including better physical security, as well as access to electricity, running water, and sewerage. As a result, credit is nearly always the optimal strategy for financing housing, whether for an outright home purchase or to accelerate the incremental building process. In today's microfinance landscape, while a number of MFIs offer housing loans, the actual volumes are essentially negligible, perhaps due in part to the complexity of evaluating and funding larger, longer-term loans. Despite their challenges, housing loans present perhaps the largest virgin territory for expanding financial inclusion.

A Framework for Appropriate Consumer Finance

MFIs can have a role to play in guiding customer behavior while refraining from passing judgment on customer behavior. A lender promoting education loans is encouraging very different behavior than a depository promoting a commitment savings account to pay for the upcoming semester's school fees, despite the fact that they're both ultimately serving the same purpose – helping clients pay for school.

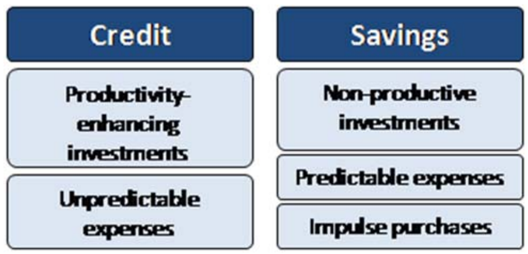
The foundational idea behind the framework is that in consumer finance, the default funding preference should always be savings, unless there is clear justification for why credit would be better suited. Stuart Rutherford's savings-credit parallel (Rutherford and Arora, 2010)[1] (saving-up in the case of savings and saving-down in the case of loans) demonstrates that the cash-flows of both approaches are essentially the same. The obvious difference, of course, is that borrowing allows the benefit of immediate spending, though at a cost. Interest is naturally part of that cost, but so is credit's constant companion: the risk of over-indebtedness, which increases with growing levels of debt. After all, future income is

[1] Rutherford, S. and S. Arora (2010), *The Poor and Their Money*, Practical Action.

never fully certain, but loan repayments are. As a result, for each spending decision, credit should demonstrate sufficient advantages over saving to overcome the added risk and cost.

There are two main types of expenditure for which credit should be the preferred vehicle over savings (Figure 1). The primary one is when the object being funded can significantly increase household productivity. As with business investment, the metric here is straightforward: if the opportunity cost engendered by the delay required to save-up the needed sum exceeds the cost of credit (both in terms of interest and risk to the borrower), then credit should be the preferred vehicle.

Fig. 1

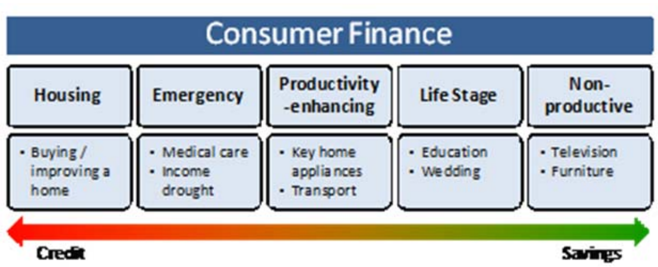


The second type of expenditure where credit is preferable to savings is unpredictable expenses. This category is not really about finance but psychology. Saving for unpredictable expenses, such as medical care, seems to be more difficult (Wang et al., 2008)[2] than for predictable ones, such as school fees. That makes credit a critical tool for dealing with emergency spending needs. But emergency is a relative term, and the immediate availability of credit makes it also a perfect tool for funding impulse consumer goods purchases. This problem is best addressed by taking the impulse out of the process, using savings schemes designated for such aspirational but otherwise non-productive goods.

Applying the appropriate consumer finance framework

These guidelines for the relative appropriateness of credit over savings are not hard and fast. Attempting to regulate client use of financial tools would actually miss the point of the appropriate consumer finance framework. That said, respecting client decisions doesn't prevent financial institutions from using more subtle methods to gently influence client behavior. To understand how this might work in practice, it's useful to separate consumer finance into five categories (Figure 2):

Fig. 2



[2] Wang, H., H. Moll, and S. Fan (2008), "Comparative analysis of farm households on financing medical care in rural China," *The Chinese Economy*, 41(6):56–74.

Productivity-Enhancing Goods

Productivity-enhancing goods are another segment that has been largely ignored by microfinance providers. Items such as washing machines replace hours of back-breaking labor. The primary obstacle to acquiring a washing machine is not funding, but housing infrastructure: running water, sewerage and electricity. But even households with these elements in place may still take some years to acquire these time-saving appliances, creating an opportunity for MFIs to nudge their clients with appropriately-designed home appliance loans. And for MFIs with a special focus on the poor, more relevant still may be the funding of basic items, such as the improved cooking stove (ISB, 2011)[3], which needs no infrastructure, but which has the potential of conveying very real benefits in greater productivity and improved health.

Life Stage Costs

Life stage costs is one area that is often served using credit, but would often be better served via well-designed savings products. This may seem counter-intuitive – after all, education is a highly productive investment. The problem with education is that its payoffs may come decades later and are often experienced slowly over time. In the absence of some type of subsidy that allows lenders to offer long-term education loans, clients often resort to relying on short-term credit to pay for education. But because productivity returns cannot be realized over a short period, such use of credit cannot be justified within the framework of appropriate consumer finance. On the other hand, most education expenses are eminently predictable and are thus perfectly suited for funding via commitment savings, where the payment schedule can be created to perfectly match the required expense when the time comes. Other life stage costs such as weddings, festivals, rites of passage, etc. meet the requirements for appropriate consumer credit, but they are all predictable expenses, making them ideally suited for savings products.

Non-Productive Goods

Non-productive goods and services, such as televisions, are often aspirational goods for low income families. However, they do not provide any direct productivity benefits. Thus, they should not be funded with credit, even though they are frequently purchased that way, often with loans from the retailer or an affiliate institution. There is no need for MFIs to tackle this problem head-on – it is both unnecessarily challenging and even counter-productive for institutions to second-guess borrower spending decisions. However, the issue can be approached indirectly, by providing commitment savings products aimed at acquiring items that clients aspire to own. Most individuals intuitively recognize that buying such goods on credit is not ideal, even if impulse decisions often trump their better instincts. Like a child with a piggy-bank, a consumer already enrolled in a commitment savings plan for an aspirational consumer good, with a maturity date timed to go with a chosen holiday or celebration, will find himself more able to resist impulse buying. The key is to offer savings products specifically tied to a given goal, as opposed to simply providing a generic savings account.

Safely Navigating Consumer Finance

For MFIs that have or are seeking to expand beyond the traditionally narrow scope of microenterprise lending, the framework laid out above can provide guidance for serving low income clients in a way that is appropriate to their needs. Expansion into consumer finance – both credit and savings – should be an important component of many MFIs' financial inclusion strategy. One often hears the critique that MFIs venturing into consumer lending are losing sight of their mission and taking on risks they do not understand. However, MFIs are already funding consumer spending through their ostensibly microenterprise loans. In fact, the frequent repayment schedule of standard microcredit loans, often

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[3] ISB Wadhwani Centre for Entrepreneurship Development (2011), "Case #2: Improved Cook Stoves," The Indian School of Business.

starting on week one, is actually closer to consumer credit (Bauer et al., 2009)[4] than it is to business investment loans [and may actually depress microenterprise investment (Field et al., 2010)[5]].

Many MFIs have employed only basic savings products, often in the form of time deposits. Better tailored accounts, especially those linked to specific needs – such as school fees or aspirational consumer goods – would help clients reduce the cost and risk for funding planned expenses, while also supporting better financial decision-making. The key is to maintain an understanding of what constitutes appropriate consumer finance, and design and market products accordingly.

Emergencies and Unforeseen Events

Emergency expenses are a critical part of consumer credit. The choice of credit for emergency uses makes both intuitive and economic sense. When an emergency strikes, the primary objective is to raise the needed funds quickly, which is the domain of credit. Unexpected medical expenses are just an extreme example of what is one of the most common needs in consumer finance – consumption smoothing (Collins et al., 2009)[6]. For many poor families, incomes come in spurts, but the need to eat is daily. Normally, this would argue for a savings-based approach of funding ongoing household needs, but the frequent unpredictability of income requires the ability to tap into a small, but dependable source of credit, perhaps even a credit line. A loan product along the lines of Grameen Bank's top-up (Rutherford, 2006)[7] capability partly answers this need, while P9 from SafeSave (SafeSave, 2013)[8] enables clients to smooth consumption by both saving and borrowing at the same time.

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[4] Bauer, M., J. Chytilová, and J. Morduch (2012), "Behavioral Foundations of Microcredit: Experimental and Survey Evidence From Rural India," *American Economic Review*, 102(2): 1118-39.

[5] Field, E., R. Pande, and J. Papp (2010), "Does Microfinance Repayment Flexibility Affect Entrepreneurial Behavior and Loan Default," Institute for Financial Management and Research and Poverty Action Lab.

[6] Collins, D., J. Morduch, S. Rutherford, & O. Ruthven (2009), *Portfolios of the Poor: How the World's Poor Live on $2 a Day*. Princeton University Press.

[7] Rutherford, S. (2006), "GRAMEEN II: the first five years, (2001-2005)," Microsave.

[6] SafeSave (2013), "Description," SafeSave.