IMPACT OF A GRACE PERIOD IN MICROFINANCE LOAN CONTRACTS

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How does the structure of a micro-credit product influence how the loan is used and impacts a household? With some variation, micro-credit is disbursed via fairly uniform products and lending mechanisms. Additionally, loan repayment typically begins immediately following disbursement. A Centre for Micro Finance study in Kolkata examines the impact of introducing flexibility into the repayment schedule, specifically through adding a two-month grace period.

POLICY QUESTIONS[1]

Microfinance is portrayed as a vein through which micro-enterprises are jump-started and expanded, leading ultimately to economic growth for the impoverished. However both microfinance practitioners and researchers would concur that clients often do not use micro-credit to found or invest in businesses. There could be several forces behind this, including the natural variety in household aspirations/characteristics, which were part of findings by Banerjee et al.[2] Another possibility is that microfinance products are designed, both in size or structure, to minimize default and not for optimal client investments.[3]

To investigate this latter dynamic, the Centre for Micro Finance and economists from Harvard and Princeton Universities have partnered with Village Welfare Society (VWS), a microfinance institution, to introduce flexibility into the standard microfinance contract. Most microfinance contracts mandate that repayment begins almost immediately after the loans are disbursed. The CMF research team introduced a two-month grace period for a subset of VWS clients and monitored how the changes in liquidity impacted household investment behavior.

The Village Welfare Society (VWS), a microfinance institutions based out of West Bengal, allowed the Centre for Micro Finance to engage with their clients for this project. VWS lends only to women and targets entrepreneurially-inclined households that run on under $2/day. Groups at VWS range from eight and thirteen clients and members

1.Results for this briefing are taken from "Does Microfinance Repayment Flexibility Affect Entrepreneurial Behavior and Loan Default?" Erica Field, Rohini Pande, and John Papp. October 2009. Available at **http://ifmr.ac.in/cmf/publications/wp/2010/34_Field_Flexibility_Repayment.pdf**
2.Results taken from "The Miracle of Microfinance? Evidence from a Randomized Evaluation," by Esther Duflo, Abhijit Banerjee et al which was published in May 2009. This paper is available at: **http://ifmr.ac.in/cmf/publications/wp/2009/31_Banerjee_Miracle_of_Microfinance.pdf**
3.See "Competition and Multiple Borrowing in the Indian. Microfinance Sector" by Karuna Krishnaswamy. Available at **http://ifmr.ac.in/cmf/publications/wp/2007/17_karuna-competition.pdf**

receive an initial loan of Rs 4000 (~USD $80), with subsequent loans ranging up to Rs, 12,000; while repayment meetings are in groups, liability is largely individual.

INTERVENTION

VWS and the CMF research team created 169 groups with five members apiece, totaling 845 clients. Eighty-five groups were randomly assigned to the standard VWS contract with immediate repayment and eighty-four groups were randomly assigned to the tweaked contract with a two-month grace period. Aside from the two-month grace period, the loan contract was identical and clients were required to repay fortnightly over the course of forty-four weeks. A baseline survey was conducted between April and August 2007 to gather information on household business activities, demographics etc, and an end line survey was conducted between January and November 2008, roughly one year after the loans had been disbursed. In the end line survey the clients provided information on how they had spent their VWS loan. The research team also tracked default and delinquency by using VWS administrative data cross-checked with loan officers.

FINDINGS

For all clients, those with and without a grace period, the most significant use of their loan, 80%, was on business-related activities; the second largest category was house repairs. But there are also notable differences in spending between the two groups of clients. For example, clients with the two-month grace period spent roughly 8% (Rs. 462) more on business items, than clients without the grace period. When business expenses are further broken down, clients with the grace period spent more on inventory and raw materials than clients without a grace period. Additionally, while the rate of new business formation among the clients is low, around 2% of clients, the likelihood of starting a new business is doubled among the clients with the grace period. Thus it appears that the two-month grace period encourages clients to invest more in their business and to spend more on illiquid, and possibly more risky, inputs such as raw materials.

A second category of findings relate to client delinquency and default. The research team examined and compared patterns of delinquency between clients with and without the grace period. Clients with grace period were on average, between 6 to 8 percentage points more likely to default on their loan than clients without a grace period. Four months, or sixteen weeks, after the final loan installment was due, 3% of non-grace period clients had failed to repay and 11% of grace period clients had failed to repay.

IMPLICATIONS

When combined, the findings from the two categories of impact, investment and default/delinquency, suggest that clients who are given a grace period invested more in their businesses and in illiquid components, but increased their risk of default. These results present interesting tradeoffs for microfinance institutions that are driven by the twin goals of a) encouraging business-formation/growth among clients and b) desire to keep default at a minimum. In future research, the project will compare data on business profits and returns across both groups.