How Do Microfinance Clients Understand their Loans?

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Executive Summary

In recent years, discussions on microfinance policy and regulation in India have tended to centre on the extent to which small borrowers understand their loans and the financial liability implicated therein. The paper aims to provide an explanation of how MFI clients understand their loan contract and the implications for policy. We find that small borrowers are able to identify the size and duration of the loan and their weekly instalment on their loan. However, they know very little about the interest rate and total interest expense on the loan. Additionally, a majority of the clients find what are commonly viewed as coercive collection practices to be acceptable. The results of this survey indicate clients think about their loans in terms of how much they actually owe on a weekly basis. Thus, top-down regulation which hinges on the assumption that borrowers are able to calculate and understand their interest rates, would likely not succeed in protecting small borrowers.

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1. Introduction

In recent years, discussions on microfinance policy and regulation in India have tended to centre on the extent to which small borrowers understand their loans and the financial liability implicated therein. Lack of financial awareness can lead to over-indebtedness and greater economic vulnerability for the very clients that microfinance seeks to help. These concerns were first brought to the forefront in India by the face-off between microfinance institutions (MFIs) and the district administration in Andhra Pradesh. MFIs in the area were accused of predatory lending, overburdening poor and illiterate women with loans which they may not have been able to repay and using coercive collection practices to ensure repayment. Indeed, the voluntary code of conduct developed by Sa-Dhan[2] after the Andhra Pradesh crisis in 2005 recommends that MFIs be fully transparent in the communication of loan details, interest rates and the calculation thereof. Thus, improving financial awareness as a means of protecting the small consumer has become a key policy focus in microfinance.

This study aims to understand how MFI clients understand their loan contract and exactly what it means for an MFI client to be informed. This study goes beyond assessing whether an MFI client knows the terms of his loan. Rather, it explores which aspects of their loan terms are important to MFI clients and what are the implications thereof for regulation.

This study is particularly relevant in today's context when financial literacy has become the new buzzword in the arena of access to finance, both globally and in India. One reason financial literacy has become so central is the dizzying array of financial products from which households can choose. It has also been alleged that the recent sub-prime crisis originating in the US was precipitated in part by the lack of financial acumen of the sub-prime borrowers. In India, potentially incendiary situations arose in Andhra Pradesh, most famously, as well as in Orissa and Karnataka, when MFIs were accused of overburdening poor and illiterate borrowers with loans they could not repay. Various solutions have been proposed including more stringent regulation, capping MFI interest rates, mandating precise disclosure rules for MFI interest rates and stipulating that they provide scrupulous details to

[2] Sa-Dhan is an association of microfinance institutions in India. The voluntary code of conduct is available here: http://www.sa-dhan.net/corevalues.pdf

their clients and policymakers on how they arrive at the interest rates they charge. However, if clients do not understand interest rates or see their loans in very different terms, regulation could potentially backfire. These concerns and their policy responses beg the following questions:

- How well and in what terms do poor borrowers understand their loans?
- How do poor borrowers view collection practices, and which ones do they find coercive?
- To what extent is regulation consistent with the understanding that MFI clients have of their loans and MFI collection practices?

Our results suggest that small borrowers are able to identify the size and duration of the loan and their weekly instalment on their loan. However, they know very little about the interest rate and total interest expense on the loan. Additionally, a majority of the clients find what are commonly viewed as coercive collection practices to be acceptable. The results of this survey indicate clients think about their loans in terms of how much they actually owe on a weekly basis. Thus, top-down regulation, which hinges on the assumption that borrowers are able to calculate and understand their interest rates, would likely not succeed in protecting small borrowers.

MFI loan contracts are typically extremely simple, keeping in mind the clientele they serve. The assumption that transparency would increase by forcing MFIs to describe their interest rates in detail and enable clients to understand their loans better may not necessarily be true. Any regulation based on this assumption may backfire. We also conclude that training which promotes various different aspects of financial literacy like budgeting, understanding one's financial rights, and better understanding debt and sources of debt may be more important.

While this study is an important step in understanding how to formulate policy that is responsive to microfinance clients and their needs, it is important to keep in mind that the small number of respondents in our survey makes it difficult to generalise the results. We conclude that more studies are needed which document existing levels of financial awareness and elucidate how greater financial literacy could improve their access to finance.

This paper begins with a short literature review of some of the major issues in financial literacy programmes and their evaluation. Then we describe the lending and operational structure of two MFIs which participated in this study. Part V and VI provide a summary and discussion of the results. Part VII concludes.

2. Financial Literacy: Definition, Measurement, and Evaluation

Financial literacy has been defined as the ability to process financial information and make informed decisions about personal finances. In the last few years, with increasing focus on access to finance as an important determinant of household-level economic development and its accompanying positive consequences for empowerment (Basu, 2005), financial literacy has become an important issue for practitioners and policymakers alike.

There are very few studies which look at levels of financial literacy, especially in developing countries. Yet the existing studies show that financial literacy levels are low across the world. Data from OECD countries shows that very few consumers regularly use basic financial management skills, such as budgeting or developing a plan for saving or retirement (Godfrey et al, 2008). In Australia, while 67% of respondents indicated that they understood the concept of compound interest, only 28% were actually able to calculate it. In developing countries, the situation only degenerates. In India, over 50% of the labourers surveyed indicated saving cash at home while simultaneously borrowing at high rates of interest from moneylenders (Financial Express, February 8, 2008). In Zambia and other countries in Africa, only a third of adults have access to bank accounts, and about half do not use any financial products (DFID, 2008).

Why is financial literacy important? Firstly, financial literacy can be an important determinant of access to finance (Cole & Fernando, 2008). Low levels of literacy may prevent the take-up of more complicated financial products such as insurance, since clients may be hesitant to buy a product whose utility they do not fully comprehend. Even for a less complicated financial product, such as a bank account, a financially illiterate person may not understand the importance of formal savings. Lack of financial literacy may also be compounded by a lack of access to a range of financial products (Godfrey et al, 2008).

Secondly, microfinance, in the last few decades, has had the effect of exponentially increasing access to credit for poor and marginalized households. Given the increasing commercialization of microfinance and the entrance of for-profit players in this sector, financial literacy has acquired new importance as a means to enhance consumer protection. While consumer protection is necessary to ensure that consumers have the information they need to make an informed decision, financial literacy gives them the competence to evaluate that information (Rutledge et al, 2008). Regulation on consumer protection usually revolves around promoting truth-in-lending practices to ensure transparency to the microfinance client and protection against abusive lending and collection practices (Microfinance Gateway, 2008). For instance, in various countries, including Panama and those in Central Africa, MFIs are required, by law, to state the Annual Percentage Rates in their loan contracts (Porteus & Helms, 2005). Both of these issues are intimately related to financial literacy and awareness. While it is important for microfinance clients to receive full information about their loans, we need to examine whether "quantity" of information necessarily implies "quality" of information (Microfinance Gateway, 2008). Similarly, the appropriate collection practices can also only be determined once existing levels of financial awareness are known. Thus, financial literacy is an important tool to enhance consumer protection.

In India, the Sa-Dhan Code of Conduct, referred to earlier in this paper, exhorts its members to disclose their interest rates and funding costs to clients by posting them inside their offices. Further, the code provides for a dispute resolution mechanism whereby microfinance clients can call a central authority to air any grievances they may have. While these efforts are laudable, it is also important to appreciate that unless MFI clients in these countries understand interest rates and can calculate them, these regulations are meaningless and will have no impact. Similarly, the Sa-Dhan redressal mechanism assumes that rural microfinance clients will have the ability and the wherewithal to make a phone call. Thus, education efforts must take into consideration what clients already know and do not know.

A third reason to discuss financial literacy stems from the movement to protect borrowers from usury by legally capping interest rates. Yet interest rate ceilings tend to hurt the ones they seek to protect the most by decreasing their access to credit (Basu, 2005). From a practitioner and policymaker perspective, innovative ways to improve financial literacy and consumer protection may be a strategic way to offer a positive alternative to interest rate ceilings (Helms & Porteus, 2005).

Finally, one of the issues that countries across the world are now grappling with is the extent to which clients are overburdening themselves with loans they cannot repay. While this point is related to the previous discussion of consumer protection, it bears repeating. One instance in which people do not appreciate the complexity of the product they have bought relates to a mortgage product that has small, fixed payments in the beginning, but a large "balloon payment" towards the end of the loan tenure. While this innovation is based on the assumption that with time, people will earn more and be able to pay more on their mortgage, it is not good for people with fixed incomes. These demands and payment schedules are crucial for clients to truly comprehend before making a commitment to a product.

Given its importance in today's context, financial literacy programmes have mushroomed, and much of the conversation on policy focuses on how to improve it. For financial literacy providers, Braunstein & Welch (2002) point out that some of the key questions include:

- *Who* to target and how to assess their information needs?
- *What* does this target audience need to know in order to understand their current financial situation, pinpoint future goals, and adopt behaviour that will allow them to achieve these goals?
- *How* can effectiveness and impact of financial literacy programmes be measured?

Let us address the third question first. One of the big obstacles in designing research which evaluates financial literacy programmes is determining how to measure success. Most of these programmes aim to improve the overall ability of participants to make financial decisions that will positively impact their economic well-being. Some programmes have very particular goals such as improving savings or reducing default on loans, while others are much broader. For the programmes which have specific outcomes, success can be defined by metrics such as lower rates of default on loans or changes in confidence levels on financial matters. For the broader programmes, it is difficult to devise parameters to measure success, although some studies look at the overall confidence level of participant households in financial matters. Furthermore, measuring 'success' is also complicated by the multi-dimensional process that determines the take-up of sound financial habits; these extend beyond financial literacy to various psychological and environmental factors. Finally, while many studies establish a correlation between financial training and improved savings or other target criteria, there are very few studies which rigorously establish a casual effect between training and behaviour (Cole and Fernando, 2008).

Today, financial literacy is measured typically by testing arithmetic ability. Indeed, as Cole and Fernando (2008) point out, financial literacy test scores are highly correlated to math test scores. This would imply that if financial literacy is based on mathematic ability, financial literacy programmes would do well to focus on basic arithmetic skills like addition, subtraction, multiplication, and division. However, if in fact financial literacy is *not* based simply on arithmetic skills, then this measure of financial literacy is not worthwhile, and we must look for alternative measures.

Although the need for financial literacy has been well documented, there is conflicting evidence on whether or not financial literacy training actually changes financial behaviour for the better. There seems to be some evidence that programmes targeting very specific competencies, such as how to calculate compound interest or how to save more, are able to have a greater impact than those which focus on the broader themes of financial management (Braunstein& Welch, 2002). The training, the format, the information provided during the training, and the quality of trainers are all-important determinants of how financial literacy programmes impact the participants. For instance, Freddie Mac conducted a study of close to 40,000 mortgages from the years 1993–1998 under an affordable mortgage loan programme. Some borrowers received pre-purchase counselling from different sources (government agencies, mortgage insurers, non-profit groups, etc.). The results demonstrated that those who received counselling had a 19% lower default rate that those who did not. Similarly, those who received individual counselling had a much lower incidence of default than those who received classroom training. Telephone counselling had no impact on default rates. The study concluded that reduction in default rates was attributable to the *type* of counselling format (Hirad & Zom, 2001). Yet another Freddie Mac-commissioned study found that consumers benefit most from practical and applied lessons, rather than learning about financial management in the abstract. The study also showed that across groups, people believed that the major source of financial learning was through a difficult financial experience (Bradley et al, 2001).

Additionally, as discussed earlier, there is evidence to show that individual character and psychological traits such as risk aversion or over-confidence have an impact on how messages from financial literacy programmes are internalized by the participants (Mullainathan & Thaler, 2000). The crux of this literature rests on the fact that in spite of having clear information, which should lead to better financial management, people do not act in their best financial interest. Some of these "irrational" economic behaviours include investing in the absence of complete information, altruism or giving to charity without any apparent benefit to themselves, and not acting consistently with expressed preferences

(Braunstein & Welch, 2001). Specifically in the context of poor borrowers, several studies have shown that consuming one less cup of tea a day and instead investing that money in their business could have dramatic implications for their overall income. Yet consumers choose not to act in a rational manner. A study conducted in South Africa showed that potential borrowers were more likely to take-up offers which had the simplest terms. In the case of male borrowers, a picture of a woman on the loan offer letter made loan take-up more likely. These results were fairly consistent across education and income levels and even for those who had a history of credit (Bertrand et al, 2006).

In short, the literature seems to recognize that there is a need for financial literacy and that a well-planned, thoughtful literacy programme which takes into account the needs of the beneficiaries it seeks to serve can be useful and have a positive impact for financial management. However, what the also literature reveals is that there is a paucity of research which looks at current levels of financial awareness. Further, there is no work on how to build upon current levels of awareness to enhance the financial lives of lower income groups, particularly with those who may not have easy access to financial information. This study seeks to bridge this gap to some degree.

3. Research Methodology

This study was conducted in two phases through the implementation of two surveys. The first phase, consisting of 299 respondents, was conducted with first-time rural microfinance clients of two microfinance institutions in distinct geographical locations, rural Karnataka and rural Uttar Pradesh. Respondents were asked to complete a survey which measured current levels of financial awareness. Particularly, this phase looked at how clients understood their loan contracts, the repercussions of default, and lastly, clients' comprehension of interest rates. The second phase consisted of interviews with 40 rural respondents in Madhya Pradesh, who were clients of the same partner organisation as that in Uttar Pradesh. In this phase, in an attempt to understand how clients choose between loan sources, respondents were asked to compare two loans and pick the cheaper loan. They were also asked questions which tested their arithmetic ability.

The study was implemented wholly in rural areas, since most of microfinance in India currently takes place in rural areas. It was also decided to restrict the study to first-time borrowers so that we would have a sense of how people who have never had access to microfinance understand their loans. For precisely this reason, we were compelled to use different respondents for phase two, since many of the respondents from the first phase would have graduated to their second loan.

4. Overview of MFI Research Study Partners

Respondents for phase one of this study were randomly chosen from amongst the clients of Sonata in Uttar Pradesh and BSS Microfinance Private Limited (BSS) in Karnataka, respectively. For phase two, respondents were chosen randomly from Sonata clients in Madhya Pradesh. A short description of each of the two organizations and their lending methodology follows.

4.1 BSS Microfinance Private Limited

BSS Microfinance Private Limited (BSS) has been involved in microfinance operations for over a decade and converted to a Non Bank Finance Company (NBFC) in April 2008.[3] They operate in 12 districts of Karnataka and have approximately 150,000 active clients. At the time of the study, BSS's lending portfolio consisted wholly of group liability loans, exclusively to women. Each BSS group consists of about five women, 7 to 12 such groups form a centre, and about 80 to 120 centres form a branch. Each centre meets separately on a weekly basis and is assigned a Centre Manager (or a loan officer). Each branch has a Field Office Manager.

Before receiving a loan, every group must undergo a Compulsory Group Recognition Training. During this training, punctuality, the necessity of paying weekly instalments on time and joint liability are emphasized. Group members also learn the 'member's pledge'. By repeating this pledge, members promise to come to every meeting without fail, utilise the loan for the said purpose, pay in a timely manner, take group and centre responsibilities seriously, and also acknowledge that everything they say has been witnessed by the 'home God.'[4] There is no explicit financial literacy training.

First time loans range from between Rs. 1,000 to Rs. 10,000. The loan tenure is always 50 weeks long. Every member receives a passbook which shows the amount due

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[3] An NBFC is one of the two for-profit legal entities which can provide microfinance services in India. According to the Microfinance India Review 2007, NBFCs account for 50% of microfinance services provided in India. NBFCs are not allowed to collect savings without meeting stringent requirements. For more information about NBFCs, see MCRIL (2005).

[4] The 'home God' is the deity that the women pray to in their houses. This pledge demonstrates how important it is for MFIs to ensure repayment and the ways in which they do so.

every week and the corresponding total principal and interest outstanding on a weekly basis. The interest rate on the loans is 15% flat, without any upfront fees.

BSS also collects a security fund of Rs. 10 every week from each group that is less than a year old. The security fund typically earns around 6% annually and is paid out to members on a monthly basis. Members also pay insurance premiums of Rs. 2 on a weekly basis. This insurance is to protect the loan in the event of death of the borrower. If, at the time of passing, the client does not have a loan, her family receives a pre-determined amount (Rs. 3000), towards funeral expenses, while if she does have a balance outstanding, the balance will also be paid through this fund.

4.2 Sonata Finance Private Limited

Sonata Finance Private Limited (Sonata) is a relatively new NBFC whose operations are concentrated in Uttar Pradesh (UP) and Madhya Pradesh (MP). Sonata is headquartered out of Allahabad in UP. In UP, Sonata has 12 branches in five districts. At the time of the study, Sonata's loan portfolio consisted wholly of group loans to women. The lending methodology is modified Grameen-style lending. Every group in Sonata consists of 10 to 20 members at the centre level.

Before receiving a loan, the group undergoes Compulsory Group Recognition Training, as in the case of BSS. During the training, social collateral, the meaning of joint liability for group members, and productive use of loans are strongly emphasised. Sonata's member pledge is similar to BSS's, with one difference. As part of training, loan officers make sure the borrower knows the interest she pays per month on every Rs. 100 borrowed from Sonata. Once again, as in the case of BSS, there is no explicit financial literacy training for clients.

First time loans range from between Rs. 2,000 to Rs. 8,000, and all loans have tenure of 50 weeks. The interest rate is 18% flat or 36% declining, accompanied by an up-front payment of Rs. 100 for processing fees and to facilitate purchase of Rs. 100 term policy insurance. Sonata has a Collection Deposit Sheet (CDS) which enumerates how much each member owes and how much was paid every week. There are two copies of this sheet, one with the loan officer and one at the Centre for record. Interestingly enough, the Sonata loan document provides a comparative pricing for other sources of credit by explicitly stating the effective interest rates from a Scheduled Commercial Bank (10-20%), the Self-Help Group Bank Linkage Programme (12%), and Sonata (36%). Sonata follows a No Cash Carry Policy for payment of loan instalments. In other words, the group leaders or representatives must go to the branch office or designated bank account of Sonata to make payments on behalf of the group at least a day before the centre meeting day.

The table below presents a comparison of terms that BSS and Sonata offer to their clients.

Table 1: Summary of First Time Loan Terms

Loan Terms	BSS	SONATA
Loan Amount	Rs. 1,000-10,000	Rs. 2,000-8,000
Tenure	50 weeks	50 weeks
Interest Rate	15% Flat	18% Flat
Processing Fees	n/a	Rs. 100 up-front
Security Fund	Rs. 10 weekly	n/a
Insurance	Rs. 2 weekly	Rs. 100 up-front

5. Findings from the Survey

This section presents findings from the two phases of the study. The first phase looks broadly at how clients understand their loans, while the second phase looks specifically at whether or not microfinance clients are able to choose the cheaper loan of two.

5.1 Phase 1: How do Clients Understand their Loans?

We begin by discussing what clients knew about their loan contracts and what clients did not know. Next, the section looks at how clients viewed practices that would be considered coercive in policy circles. Lastly, we look at who clients turn to when they require information regarding their loans or when they have grievances against their lender.

5.1.1 What Clients Know

Table 2: What is the amount of your loan?

	(% of respondents)
Right Answer	96%
Wrong Answer	4%

Table 3: What is the duration of your loan?

	(% of respondents)
Right Answer	92%
Wrong Answer	8%

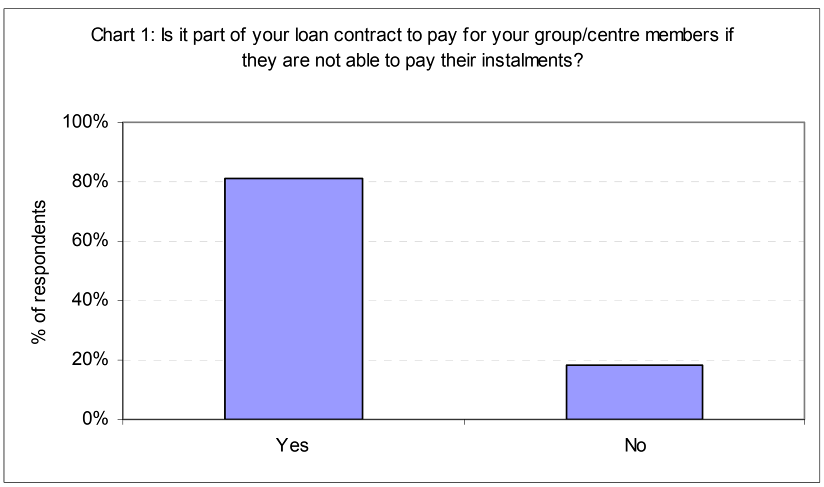
Table 4: What is the weekly instalment that you must pay on this loan?

(% of respondents)

	As written in the loan contract	Adjusting for savings in BSS	Within 10% of weekly amount
Right Answer	41%	57%	83%
Wrong Answer	53%	37%	11%
Does Not Know	3%	3%	3%
Blank	3%	3%	3%

Clients were able to state how much they had borrowed, the duration of their loan, and finally, their weekly liability on the loan as evidenced by the tables above. Table 4 seems to indicate that less than half the respondents are able to state their weekly loan liability correctly. However, this number is misleading, because BSS also collects for the security fund and insurance worth Rs. 12 every week from its clients. Adjusting for this, we find that the number of people who know their weekly liability amount increases. Finally, over 80% of those surveyed were within a 10% range of their weekly liability.

Table 5: If someone in your group/centre is not able to make the payment, do you feel obligated to pay their weekly instalment?	
	(% of respondents)
Yes, I feel obligated	40%
Yes, as others will also do so in my difficult times	40%
Yes, I feel obligated to, but only if others in my group/centre feel the same way	8%
Yes, I don't want to, but I have to since it's part of my loan agreement	4%
Yes, I should according to the loan agreement. But I won't since its not my loan	2%
No, it's not my loan and I don't have to	3%
Does Not Know	1%



The survey also asked non-hypothetical questions regarding respondents' liability on loans and looked to tease out whether joint liability played a factor. Indeed, a sense of joint liability and group cohesion seemed to be prominent among clients. When asked whether joint liability was part of client loan contracts, 81% answered affirmatively. When asked how respondents felt about paying on behalf of other group members, 40% felt obliged to pay for others, and 40% replied that they felt obliged out of the knowledge that other group members would help them in times of repayment difficulty.

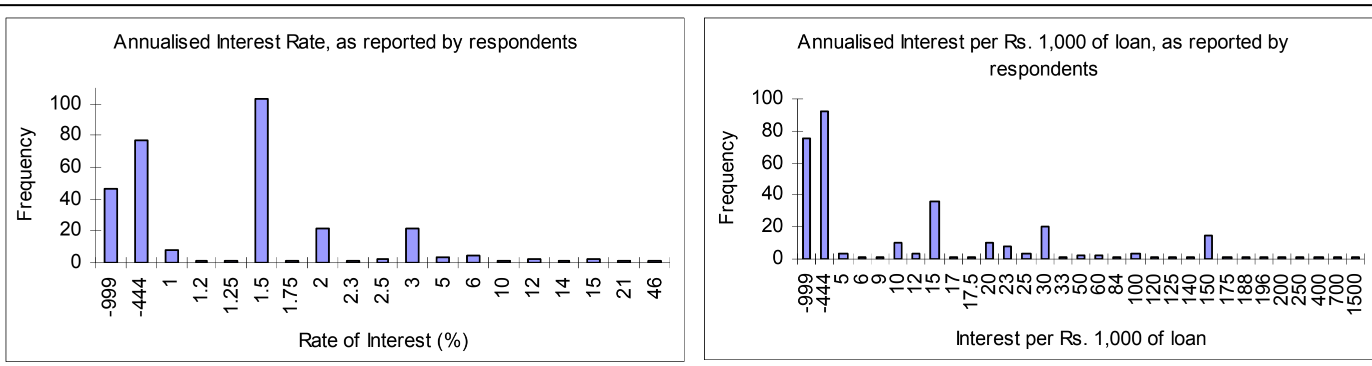
5.1.2 What Clients Do Not Know

Clients had a fairly limited understanding of total liability in rupees over the time of their loan. As we see in Table 6, even after providing 10% leeway, only 39% were able to state their total liability correctly.

Table 6: What is the total interest payment that you are required to pay over the time of this loan?	
	(% of respondents)
Right Answer	11%
Within 10% of the Right Answer	39%
Wrong Answer	50%
Tried but does not know	18%
Did not try and does not know	20%
Blank	1%

The ability of respondents to correctly identify the interest rates on their loans, either as percentages or as amounts, was severely limited as we see below. While the correct answers were 15% and 18% at BSS and Sonata, respectively, and Rs. 150 and Rs. 180 per Rs. 1,000 of loan at BSS and Sonata, respectively, only a handful of respondents were able to indicate these numbers. Interestingly, 34% of respondents specified 1.5% as the interest rate, which is essentially the monthly flat interest rate paid by clients at Sonata. While this may ostensibly indicate that clients had some awareness of interest rates, this may not be the whole truth. As we saw earlier, clients at Sonata learn this interest rate as part of their Compulsory Group Training.

Chart 2: Interest Rate, as reported by respondents



-999 Did not try and does not know
-444 Tried and does not know

Even though clients were unable to identify their interest rates appropriately, the tables below indicate that low interest rates were of considerable importance to these households.

Table 7: Why did you borrow from this MFI in particular?	
Top 4 responses	(% of respondents)
Interest rate was the lowest	49%
It is very easy to get a loan from them	31%
Most of the people in the village were borrowing	23%
I needed credit and this MFI was giving credit	20%
Note: The sum of the responses adds up to over 100% because respondents could choose up to two responses	

Table 8: What is the one thing you would like to change about your MFI loan?	
Top 3 responses	(% of respondents)
More flexible repayment (daily, fortnightly etc)	26%
Lower Interest Rate	34%
Would not like to change anything	25%

5.1.3 Arithmetic and Numeric Abilities

Given that financial literacy is often measured by arithmetic ability, our survey included questions which tested numeric skills. We started with simple arithmetic questions and followed by asking clients to calculate interest rates and compare loan products. While most could answer the simpler initial questions, almost all lost interest when the difficulty level increased. Below is the summary of some of the relevant results.

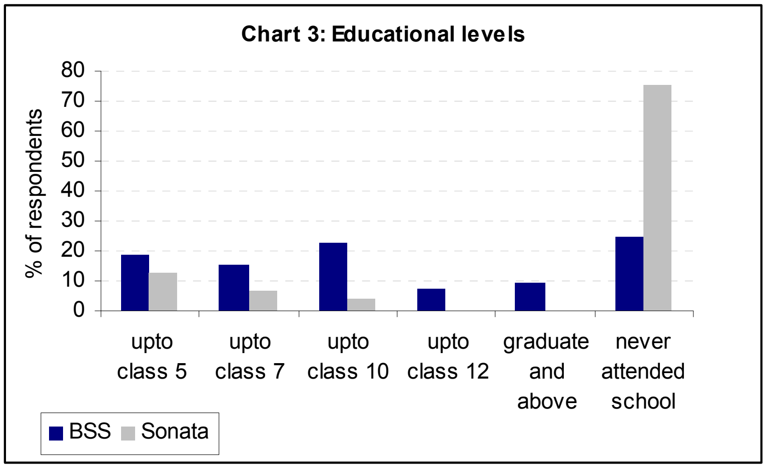
Table 9: Numeric Ability

Math Question	3+9	Word Problem 3*5	8000/10	4500*18	5500+1800	Word Problem 600/10	Word Problem 100 – 47	Word Problem 10% of 4500
% Correct Responses	81%	73%	17%	3%	31%	20%	57%	19%
% Choosing 'Does Not Know'	3%	10%	69%	92%	45%	64%	24%	70%

Note: The problems in the survey are attached in Annexure 1

While the next phase delves into the issue of numeric ability more profoundly, these results show that, measured solely by numeric ability, levels of awareness are low. For more complex questions related to interest rate calculations, more than one third of respondents chose not even to attempt the questions. Furthermore, these results combined with results from the previous section raise the question of whether, even when respondents know what their interest rate is, they are able to calculate their liability over a period of time.

In this context, it would be relevant to look at the levels of educational achievement of our respondents. As we see from the chart below, with some geographic diversity, educational levels are low, with the majority of our respondents never having attended school. While 74% of respondents in Karnataka had received some form of formal education, 75% of the respondents in Uttar Pradesh, on the other hand, had never attended school. Consequently, the mathematical understanding of respondents in the south was higher than those in the north.



5.1.3 Coercive Collection Practices

As discussed briefly in the introduction to this paper, MFI collection practices have become a central part of the debate on consumer protection for small borrowers. Part of the response has been to advocate for greater transparency on the part of MFIs and to promote awareness amongst clients on their rights.

In our survey, we presented various scenarios to our respondents. In the aftermath of the Andhra Pradesh crisis, these scenarios were typically presented, with some reason, as coercive collection practices that could and should not be tolerated by mainstream media and industry leaders.

Table 10: Coercive Collection Practices

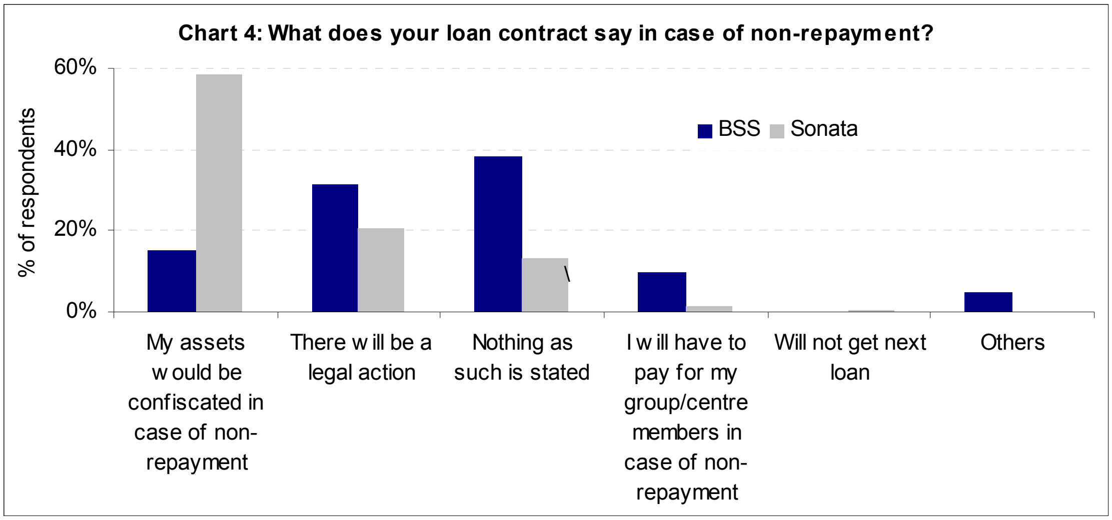
S. No.	Hypothetical Scenario Given To Respondents	Most Popular Response (%)	2nd Most Popular Response (%)
I	In case Lakshmi is not able to pay her loan and the centre manager insists on holding the meeting outside her house. What do you think about the centre manager's action?	Yes Its Alright (42%)	Its wrong and he should not do so (29%)
II	If Lakshmi doesn't repay her loan in your group, do you think it is appropriate to extend the meeting for 30 minutes to enforce repayment?	Yes Its Alright (42%)	Its wrong and he should not do so (32%)
III	If Lakshmi doesn't repay their loan in your group, do you think its appropriate to extend the meeting for three hours to enforce repayment?	Its wrong and he should not do so (36%)	Yes, Its Alright (33%)
IV	Let's say that Lakshmi is not able to repay her loan. Would it be okay for the MFI to take any of her assets such as for instance, any cows she owns, her house, her land or the machinery she uses for work?	Yes, Its Alright (53%)	Its wrong and he should not do so (22%)

As we see in the table above, there seem to be mixed feelings regarding coercive collection practices. When presented with each of these scenarios, possible participant answers included: "It is wrong, but he has to do it," "It is wrong, and he should not do it," "Yes, it is alright," "It may be right, but it would be preferable if he does not do it," or "It does not matter, it will not enforce repayment." In fact, for all Scenarios, except Scenario 3, "Yes, it is alright" was the most popular answer. While at first glance the answers seem to demonstrate a remarkable acceptance of coercive collection practices amongst microfinance clients, a closer look reveals otherwise. The second most popular response was, "It is wrong, and he should not do so." The Scenario that received the highest acceptance amongst clients was Scenario IV, in which the defaulting client's assets were seized. This is particularly intriguing, since the crux of microfinance rests on **uncollateralized lending**.

The survey also asked non-hypothetical questions with respect to respondents' responsibilities in the event of default, either by the respondents or by their peers. Once again, there was a remarkable level of acceptance for the seizure of assets, particularly with Sonata clients. Close to 60% of Sonata borrowers responded that, according to their loan contract, their assets would be confiscated in the case of non-repayment. On the other hand, around a third of BSS clients thought that legal action would be taken against them in the case of non-repayment. This may not necessarily imply that assets are in fact confiscated by the MFIs in the event of default. The threat of confiscation might be an empty one, used by loan officers simply to force defaulting clients to repay their loans, although this does not necessarily condone the use of such threats. Alternatively, clients may simply be recalling their knowledge of other types of loans, such as bank loans or moneylender loans for which confiscation of assets may be du jure cases of default.

Table 11: What does your loan contract say in cases of non-repayment?

	(% of respondents)
My assets would be confiscated in case of non-repayment	37%
There will be a legal action	26%
Nothing as such is stated	26%
I will have to pay for my group/centre members in case of non-repayment	6%
Will not get next loan	0%
Others	2%
Tried but does not know	2%
Did not try and does not know	1%



This data reveals that clients understand that microfinance loans are not free loans. They are aware that these loans require repayment and will result in undesirable consequences upon default. What is disquieting, however, is that most of these scenarios, in particular Scenario IV, go against the spirit of microfinance. This data may point towards two things: firstly, clients understand the gravity of what it means to take a loan; secondly, this data may indicate that regulation needs to focus more proactively on disclosure of collection practices, rather than simply on collection practices. In other words, instead of stepping in when clients complain that their assets have been seized by MFIs, perhaps regulators need to devise rules regarding what MFIs and their staff disclose to their clients about the consequences of default.

5.1.4 How do Clients Learn About Their Loan Contracts?

Given the information we have gathered regarding how clients view their loan contracts, it becomes important for us to understand the sources of this information. Below is the summary of data in this regard.

33% of clients believe that all rules related to borrowing are stated verbally to them, and 44% said the rules were mostly oral.

Table 12: Are the rules written on paper or transmitted orally?	
	(% of respondents)
Mostly written	14%
Mostly oral	44%
All written	3%
All oral	33%
Equal Oral/Written	5%

As per below, the majority of clients stated that the loan contract was explained to them by MFI staff. Most of the respondents also expressed satisfaction with the way in which the contract was explained to them.

Chart 5: Who explained the details of the loan to you?

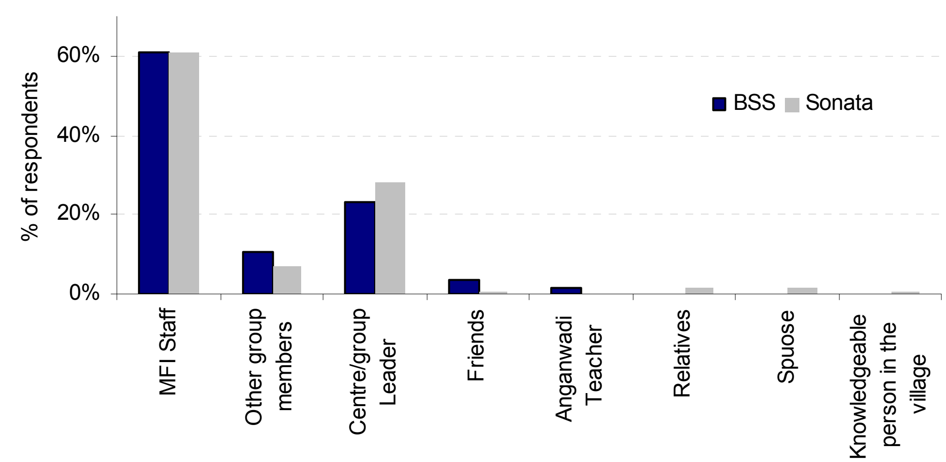
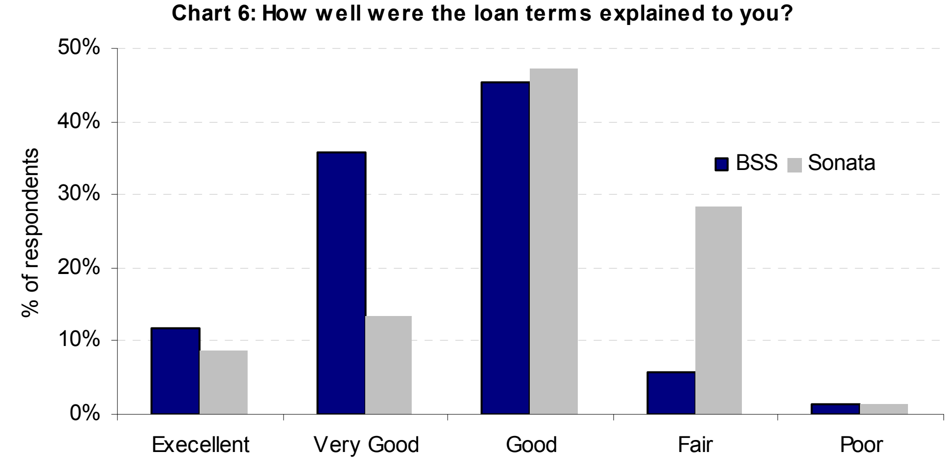
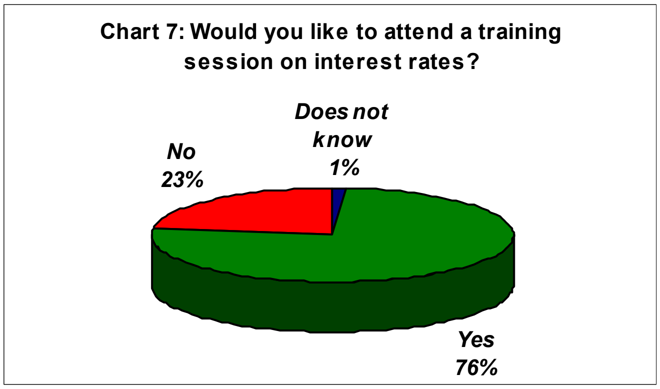


Chart 6: How well were the loan terms explained to you?





76% of respondents (65% in the south and 87% in the north) indicated willingness to participate in a training session to learn about the calculation of interest rates and weekly installments. Out of those who wanted to participate in the training, 67% were willing to pay to participate. Willingness to pay was higher in the north (62%) than in the south (38%).

Regarding doubts, the majority of respondents in the north stated that they either went to their centre leader or discussed problems with their husband. Whereas, in the south, around 32% of BSS clients said they discussed doubts with MFI staff. However, to settle grievances against loan officers, clients approached their centre/group leaders. Centre leaders were frequently cited as playing an important role in the villages. They help MFIs to establish centres in the villages, and most are considered a point of contact between MFIs and clients. Centre leaders also make MFI staff members aware of client perspectives.

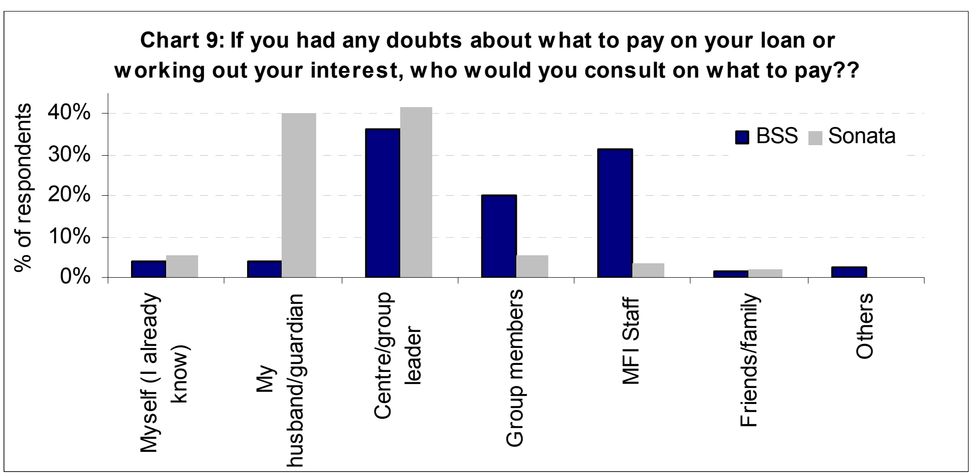


Table 13: In case of grievance/complaint against loan officers, who do you normally go to?		(% of respondents)
	BSS	Sonata
Centre leader	44%	63%
Spouse	4%	13%
Other group member	11%	5%
Never had a grievance	5%	0%
MFI staff members	28%	4%

5.2 Phase 2: How do Clients Choose Loans?

The results from Phase 1 strongly indicate that clients have limited information about their loans and limited ability to calculate interest rates. Nonetheless, interest rates are important to them, and they are eager to pick the cheapest loan possible. Finally, there is a high level of tolerance for what would generally be considered coercive practices amongst microfinance clients. How then do clients decide which loans to choose, given that, using conventional norms of measure (i.e., arithmetic skills), they possess low levels of financial literacy?

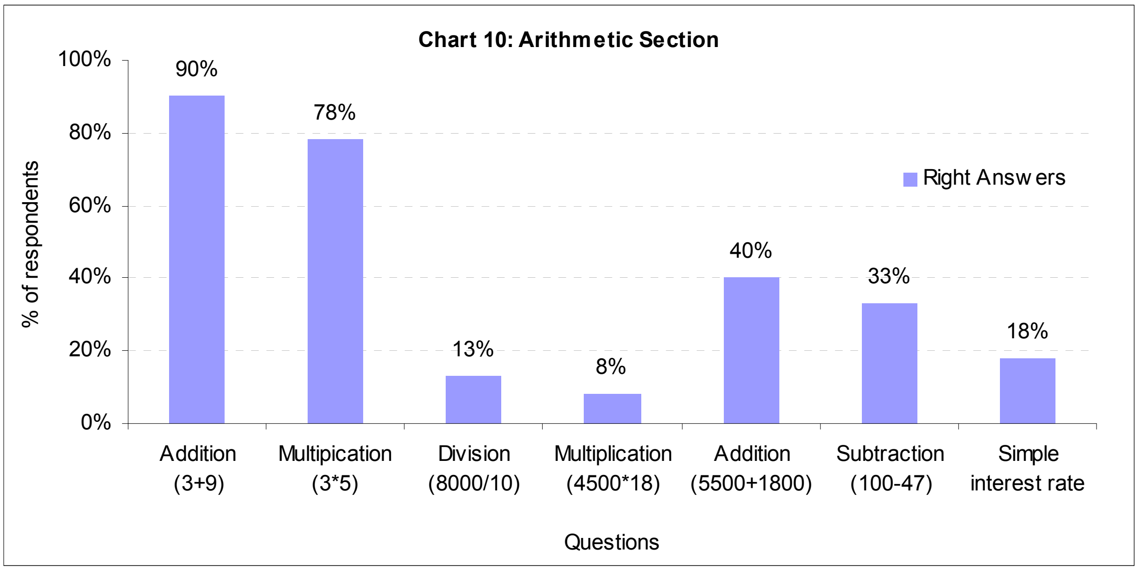
To elucidate the answer to this question, we conducted a second, much shorter survey with 40 respondents in eight villages around Jabalpur, Madhya Pradesh. In the second round, respondents were asked to choose the cheaper of two available loans. The choices were presented in terms of interest rate plans or frames. The interest rate plans varied between monthly, weekly, annual, absolute amount, flat, and declining interest.

For this phase, the pilot exercise was significant. During the pilot, most respondents were able to choose the correct loan schemes, which was surprising given that people had performed poorly in the arithmetic sections of the first phase of the study. Consequently, an arithmetic section was added to this survey as well. Educational levels, relevant for this section, were low amongst our respondents. 33% of respondents had never attended school, while only 40% were able to read and write.

This section is divided in two parts. The first part provides a summary of the respondents' numeracy skills, while the second part goes into detail about the ability of respondents to choose the cheaper loan, given a choice of two.

5.2.1 Arithmetic Section

The chart below describes how respondents performed in the Arithmetic section. The problems they were asked to solve are displayed in the chart in ascending order of complexity. It is noteworthy that every respondent interviewed during the survey used mental calculation to solve the problems and did not accept offers of a pen and paper, offered twice during the survey. This is not surprising given that educational levels are low.



As in the previous survey, the ability of respondents to answer correctly fell drastically as the questions increased in complexity. The questions are all given in Annexure 1.

5.2.2 Choosing the Cheaper Loan

One would assume that the ability of respondents to choose the cheaper loan would be highly compromised by the poor arithmetic skills found amongst our target population. Surprisingly, in this section we discovered that in nine of the twelve (or 75%) loan comparisons that respondents were asked to make, over 50% of the respondents were able to pick the cheaper loan.

As mentioned earlier, in this section respondents were presented two loans for which corresponding interest rates were presented in frames. Respondents were then asked to choose the cheaper loan.

The following is an example of a question asked in this section:

Table 14:

B1.9		**Lender 1**	**Lender 2**	Lender 1………………………………..1
	Loan Amount:	Rs. 8,000	Rs. 8,000	Lender 2………………………………..2
	Duration:	50 weeks	50 weeks	Indifferent between two options………….3
	Repayment Amount:	**Rs. 188 weekly**	---	Tried but does not know………………-444
	Interest Rate:	---	**24% annually flat**	Did not try and does not know………-99
	Which Lender would you prefer?			

The two frames in the question above indicate the ways in which the interest rates were presented. Thus, Frame 1 contains interest in terms of a weekly amount, while Frame 2 contains interest as an annual flat percentage. All the frames posed to respondents is attached in Annexure 2.

A summary of the results are given below. The table reveals that there seems to be no way of predicting which comparisons respondents were able to make accurately.

Table 15:

S. No.	Loan Comparisons		% of respondents who answered accurately
	Frame I	Frame II	
1	Rate Flat Monthly	Rate Flat Monthly	93%
2	Rate Flat Monthly	Rate Flat Annually	50%
3	Amount Weekly	Amount Monthly	90%
4	Amount Weekly	Amount Monthly	28%
5	Rate Annually Declining	Rate Annually Flat	73%
6	Rate Monthly Flat	Rate Monthly Declining	53%
7	Rate Monthly Flat	Rate Declining Monthly	85%
8	Rate Flat Monthly	Rate Declining Annual	43%
9	Amount Weekly	Rate Annually Flat	68%
10	Amount Weekly	Rate Annual	28%
11	Amount Weekly	Rate Annual	70%
12	Rate Declining Annual	Rate Flat Annual	65%

Note: Highlighted pairs were answered correctly by at least half the respondents

Let us use the illustrative example of asking people to compare between flat monthly versus monthly declining, two scenarios that elicited different levels of accuracy – 53% for the first question and 85% for the second. Similarly, for declining annual and flat annual, 65% picked the cheaper loan, while only 43% chose the cheaper option between annual declining and flat monthly. Three comparisons between weekly amount and annual rate, staggered in different places in the questionnaire resulted in three different answers. For the three comparisons, 68%, 28%, and 85% of respondents chose the cheaper loan, respectively. 28% of the respondents correctly chose the cheaper loan from a weekly and monthly amount repayment schedule, while 85% chose correctly when comparing a declining monthly and flat monthly rate. The latter is a far more complex calculation than the former.

These results indicate that respondents were using their intuition and some level of guesswork to arrive at the correct answers. Thus, it is difficult for us generalise exactly how respondents arrived at the correct response. However, it is interesting that individuals with very low literacy levels and arithmetic skills were able to choose the cheaper loan 75% of the time.

6. Discussion of Results

This study was an attempt to examine how clients understand their loans in the context of rising concerns over financial literacy, consumer protection, and reckless lending. The results from this study are intriguing in that they demonstrate that clients have a limited understanding of their loans. However, in spite of their weak numeric skills, when presented with two sets of loans, microfinance clients are generally able to choose the cheaper of the two. While examining the results of the study, it is worthwhile to note that the findings are constrained by the small sample size of respondents in our study, particularly in Phase 2.

Clients are able to understand only certain aspects about their loans. They understand how much they have borrowed, for how long, and their weekly liability. They also understand that joint liability, or paying for their centre/group members, is a central requirement of their loans. Clients do not seem to know what their interest rates are. Those that do know their interest rates have an extremely limited arithmetic ability and are unable to calculate actual interest amounts using the rates. Our respondents also accepted many collection practices that are generally considered coercive (such as the seizing of assets in the event of default) to be an acceptable penalty for non-repayment. Additionally, in spite of their partial misunderstanding of loan terms, they expressed a high degree of satisfaction loans were explained to them by MFI staff. Finally, our respondents, although of poor educational backgrounds, were able to choose the cheaper loans out of a given pair of loans even when the interest rates were expressed differently in each loan.

What do our findings indicate for financial literacy and its impact on small borrowers? From our survey, it is clear that access to finance was an important issue, since clients stated that one of the reasons for borrowing from their respective MFIs was availability. It is not clear, however, that access is affected by current levels of financial awareness. As we see from Phase 2 of our survey, clients were still able to figure out the cheaper of two loans. This conclusion merits a few caveats. Firstly, here we refer only to access to a microfinance loan which is a fairly standard and simple financial product. Access to more complicated products, such as insurance, may still require higher levels of awareness than we discuss here. Secondly, Phase 2 of our project consisted only of forty respondents, which is too small a sample to generate results that can be generalised. Thirdly, access to finance is affected by more than just ability to choose the cheaper loan. It may also be affected by ability to budget in order to repay in instalments, amongst other things.

This paper discusses the importance of financial awareness for consumer protection. Policymakers, both in India and abroad, have been pushing for MFIs to explicitly state their interest rates to the extent that some have asked for breakdown to show clients the different components of the cost to the end user. The results from our survey show that clients do not think of their loan in terms of interest rates, although interest rates are important to them. They also do not have the ability to compute interest rates. A second concern in the area of consumer protection is to what extent small borrowers understand their financial rights. Here it is clear that there is some work to be done in regulating the disclosure of default penalties by MFIs. We see that a majority of our respondents felt that confiscation of their assets had been included in their loan contracts, and thus warranted, in the event of default. While this answer may refer to informal threats by loan officers simply to motivate clients to repay, this may indicate that policymakers need to regulate what MFI can communicate to clients about the consequences of default, rather than wait for these events to take place. For instance, regulation can mandate that loan officers may not under any circumstances exaggerate the penalties of default.

Financial literacy is typically measured by assessing arithmetic ability. While this study is by no means a comprehensive measure of financial literacy, it is clear that microfinance clients do not need to have high arithmetic ability to choose the of two loans. While this study does not necessarily shed light on this issue, financial literacy training involves not only change in levels of knowledge about financial products, but also behavioural change. The latter is much harder to measure. This study indicates that more work needs to be done in understanding how financial literacy training can incorporate current levels of financial awareness to induce positive changes in financial behaviour.

The results underscore the importance of social ties in microfinance. Loan Officers and Centre Leaders are the first source of information for most of the respondents. Thus, it may make sense to equip these 'elites,' especially Centre Leaders, with greater information that they can then pass on to other microfinance borrowers. This suggestion is made in light of the fact that financial literacy training is often time-consuming and expensive. If a small number of influential women can be trained, there may be positive externalities for the community as a whole.

7. Conclusion

This data provides us with some interesting leads to answer the question of what it means for a client to be informed. In this instance, small borrowers were able to identify the size and duration of the loan as well as their weekly instalment. Many of the borrowers also recognized that non-repayment could have potentially harmful consequences. However, they knew very little about the interest rate and total interest expense on the loan.

This study argues for regulation that would require financial institutions to provide clients with information which they are able to understand and use. The data here shows that clients are able to understand the liability on their loan in terms of weekly repayments, rather than in terms of interest rates. A majority of the clients seem to find what is commonly viewed as coercive collection practices to be acceptable.

In conclusion, the results of this survey indicate that the way we currently think about how clients understand loans may not be reflective of ground realities. Firstly, clients think about their loans not in terms of interest rates and interest expense but rather in terms of how much they actually owe on a weekly basis. Secondly, it is both unreasonable and unrealistic to expect small borrowers to have a deeper understanding of their loans than borrowers who have greater access to information and finance. Thus, top-down regulation which works under the assumption that borrowers should be able to calculate and understand their interest rates will not succeed in protecting small borrowers.

Finally, this study, while useful for preliminary understanding of how small borrowers think of their loans, is limited in scope. For instance, one can speculate that this group of respondents is not unique in any way, that a survey of middle-class borrowers would elicit a similar level of financial literacy. As such, much greater research is required to examine in greater depth how small borrowers understand their loans and how they use this understanding to make financial decisions.

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Annexure 1

Questions to test numeric skills in Table 9: Numeric Ability and Chart 10: Arithmetic Ability

1	If you have 3 Rupees and your group member gives you Rs. 9, how many Rupees do you have?
2	If you have five friends and would like to give each one three pots, how many pots must you have to give away?
3	8,000/10 =
4	4,500 X 18 =
5	5,500 + 1,800 =
6	What is one one-tenth of 600?
7	You want to buy baskets worth 47 Rs. If you pay the shopkeeper with a 100 Rs. note, how much change will you get?
8	If the interest rate on your loan was 10% and the loan amount was 4500, what is the total interest you would be paying on this loan?

Annexure 2

Questions where respondents pick the cheaper loan in Table 14 and Table 15: Loan Comparisons

1		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Interest Rate:	**1.5% flat per month**	**3% flat per month**
	Which Lender would you prefer?		
2		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Interest Rate:	**3% flat per month**	**25% flat per year**
	Which Lender would you prefer?		
3		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Repayment Amount:	**Rs. 188 weekly**	**Rs. 230 weekly**
	Which Lender would you prefer?		
4		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Repayment Amount:	**Rs. 188 weekly**	**Rs. 700 monthly**
	Which Lender would you prefer?		
5		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Interest Rate:	**18% annually declining**	**18% annually flat**
	Which Lender would you prefer?		
6		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Interest Rate:	**2% monthly flat**	**3% monthly declining**
	Which Lender would you prefer?		
7	You are taking a loan of Rs. 8,000 for 50 weeks. Your two options are: **Option** 1: The monthly interest rate on your loan is 4% monthly. Flat means every loan instalment; you pay same interest rate on the total principal amount that you borrowed. **Option 2:** The monthly interest rate on your loan is 3% declining. Declining means every loan instalment; you pay interest on that portion of the loan		

	which is outstanding.		
8		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Interest Rate:	**2% flat monthly**	**20% declining annual**
	Which Lender would you prefer?		
9		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Repayment Amount:	**Rs. 188 weekly**	**---**
	Interest Rate:	**---**	**24% annually flat**
	Which Lender would you prefer?		
10		**Lender 1**	**Lender 2**
	Loan Amount:	Rs. 8,000	Rs. 8,000
	Duration:	50 weeks	50 weeks
	Repayment Amount:	**Rs. 230 weekly**	**---**
	Interest Rate:		**36% annually**
	Which Lender would you prefer?		
11	You are taking a loan of Rs. 8,000 for 50 weeks. Your two options are: **Option 1:** The weekly interest on your loan is Rs. 200 **Option 2:** The annual interest on your loan is 18%		
12	You are taking a loan of Rs. 8,000 for 50 weeks. Your two options are **Option 1:** The annual interest rate on your loan is 21% declining. **Option 2:** The annual interest rate on your loan is 21% flat.		