Should Flexibility Matter? A Poor Consumer's Perspective of Flexible Micro Loans

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Abstract

Repayment schedules characterizing a typical micro loan are rigid and offer little to no flexibility in terms of rescheduling repayments when faced with emerging contingencies. Such rigid structures affect the economic as well as the psychological well-being of the poor leading to underinvestment of the borrowed capital, lower motivational levels and lowered sense of psychological well-being among the underprivileged. Flexibility in loan contracts and repayment schedules can alleviate these adverse effects on the poor and bring the microfinance institutions closer to their goal of poverty alleviation and welfare objectives. In this article, a case is made in favour of flexible loan contracts and repayment schedules based on the psychological underpinnings of decision making among the underprivileged. Implications of such loan contracts on consumer welfare and the microfinance institutions (MFIs) are discussed.

Keywords

Micro loans, microfinance institutions, flexibility, consumer psychology

Introduction

A typical micro loan is characterized by frequent and regular repayments starting within a week after loan disbursement. Most microfinance institutions (MFIs) and many researchers highlight the fiscal discipline that this design imparts on loan repayment behaviour among the impoverished consumers. However, these loan structures are rigid and offer little flexibility in terms of rescheduling repayments depending on emerging contingencies. This characteristic does two things from the psychological point of view of the poor consumer. First, frequent and regular repayments make the consumers focus heavily on servicing the loan vis-à-vis focusing their attention and investing their energy towards seeking out investment opportunities with the possibility of generating higher income streams. Even in some cases, the lack of flexibility forces the consumer to fulfil the initial repayment obligations from the borrowed capital itself. In short, greater focus towards fulfilling the immediate repayment obligations makes these consumers myopic and risk-averse resulting in underinvestment of the borrowed capital in smaller income-generating opportunities characterized by smaller, sooner and stable cash flows (Field, Pande, Papp & Park, 2012; Karlan & Mullainathan, 2006). Such smaller capital rarely has the ability to extricate the poor from the poverty trap and the poor continue to remain poor over time (Banerjee & Duflo, 2011). Secondly, the perceived lack of control due to the inability to reschedule repayments undermines autonomy, which in turn has adverse effects on the psychological welfare of the poor (Chakravarti, 2006; Moller, Ryan & Deci, 2006).

From a broader perspective, rigidity in repayment schedules serves as an impediment towards attaining the socio-economic and the socio-psychological objectives of poverty alleviation: the economic welfare of the poor and their psychological well-being (Narayan-Parker & Patel, 2000). In fact, Field, Pande, Papp & Park (2012) observed that changing the repayment schedule from weekly to monthly, thereby introducing flexibility

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in the repayment schedule, reduced financial stress among the poor significantly and induced them to invest in larger income-generating enterprises. Given the complex nature of poverty as a multidimensional construct involving both economic deprivation and psychological well-being as indicators (Chakravarti, 2006; Narayan-Parker & Patel, 2000), it is imperative that policy makers and MFIs take a holistic view in designing products and planning for interventions to address the poor consumers' fundamental needs of economic prosperity and psychological well-being. In this article, a case is made in favour of flexible micro loans and flexible financial products in general, based on the tenets of consumer psychology. Implications for consumer welfare and the MFIs are discussed thereafter.

Impact of Rigid Loan Contracts and the Need for Flexible Repayment Schedules

As mentioned in the preceding section, the main argument in favour of rigid loan contracts is that they impart fiscal discipline among the poor who may otherwise default on their obligations. Microfinance institutions selling such products boast of very high repayment rates (approximately 98 per cent), which rival that of many large multinational financial corporations (Karim, 2011). However, these high repayment rates do not necessarily reflect the poor consumers' volitional actions towards honouring their debt obligations. Oftentimes, MFIs resort to coercion and high-pressure tactics to recover the payments from the poor borrowers (Karim, 2011). Further, defaulting on repayments draws severe penalty in the forms of substantial reduction in future borrowing capacities, humiliation, shame and loss of face among community members, among others. Due to the very large number of consumers a given MFI services, it is not cost-effective for these institutions to uncover or understand the reasons behind any particular consumer defaulting on their repayments. The natural consequence of this is management by exception; once a consumer falls short of making the repayments, their accessibility to credit from formal sources like the MFIs becomes severely curtailed and they eventually fall back on local moneylenders charging usurious interest rates for credit. Thus, rigidities in loan contracts heighten the fear of defaulting which in turn leads to risk rationing wherein consumers do not borrow to begin with and are excluded from the market (Boucher & Guirkinger, 2007; de Janvry, Sadoulet, Coulibaly & Abordonado, 2013; Hwang, 2011). Further, frequent and regular repayments also increase financial stress (Field, Pande, Papp & Park et al., 2012; Prelec & Loewenstein, 1998). Stress and anxiety subsequently affect financial decision making wherein decision biases are exacerbated leading to irrational preferences among the poor (Porcelli & Delgado, 2009).

Stress can also rise due to purely cognitive reasons. The poor may be highly conflicted between the task of keeping track of regular repayments (a recurring cost) and the need to think of ways to invest the borrowed capital in the most productive manner (Prelec & Loewenstein, 1998). Such conflicts result in wastage of cognitive resources which in turn prevents them to think of the long-term implications of their financial decisions. Thinking of the future is an effortful endeavour, especially for the poor (Chakravarti, 2006). The continued state of deprivation leads to a vision of a very bleak future devoid of material progress and economic prosperity, wherein the future construals become loosely defined or hazy (Chakravarti, 2006). A continued state of deprivation also makes the poor focus on the immediacy of subsistence wherein decision making revolves around the immediate concerns of well-being (Chakravarti, 2006). Such a psychological orientation towards decision making further heightens a consumer's focus on the short-run and lower-level feasibility-related aspects of making repayments. This orientation may subsequently manifest itself in a higher preference for a smaller micro loan requiring smaller repayments and lower effort and time investments with the potential of producing only smaller income streams, over larger loans requiring higher repayments, time and effort investments but with the potential of generating much higher income.

Thus, underinvestment of the borrowed funds in lower income-generating opportunities can result from factors both external (socio-economic factors) or purely internal to the decision maker (psychological factors). Both these factors are, however, due to the rigid loan structures or the frequent, regular repayment schedules which characterize typical micro loans.

Finally, rigid loan repayment schedules affect the poor consumer in another fundamental way once the micro loan is acquired and repayments are being made. The perceived lack of autonomy or loss of control over one's actions, which results due to the lack of flexibility to reschedule repayments depending on emerging contingencies, leads to suboptimal task performance, lower motivational levels and lower experienced well-being according to the self-determination theory (Chakravarti, 2006; Moller et al., 2006). The self-determination theory is an influential theory of motivation which identifies autonomy in decision making as a fundamental human need, fulfilling which leads to greater psychological well-being.

Implications of Offering Flexible Loan Contracts

Thus, the impact of flexibility, vis-à-vis rigidity in loan contracts, on the poor consumers' economic and psychological well-being is far reaching, and more in line with the objectives of poverty alleviation. It is consequently essential for MFIs and policy makers to take note of the impact which flexible contracts may have on the poor, their preferences, behaviour and well-being. However, implementation of such flexible schemes will require a change in the mindset of the MFIs; the MFIs have to move away from their existing orientation towards focusing on operational efficiencies, emerging out of fast and efficient loan disbursements and recovery (Sriram, 2010).

One of the major arguments of MFIs against flexible repayment schedules or loan contracts is that flexibility will increase default rates and subsequently lower the characteristically high recovery rates which they boast of. However, Field, Pande, Papp & Park et al. (2012) found no evidence of increase in default rates among the underprivileged consumers in the eastern state of West Bengal in India as the loan repayment schedule was relaxed from being weekly to being monthly. Similar effect of flexibility on consumer behaviour was observed in rural Bangladesh, the cradle of the microfinance revolution (Shonchoy & Kurosaki, 2013). However, de Aghion and Murdoch (2005) reported an increase in default rates among borrowers in rural Bangladesh with greater flexibility in contracts in contradiction to the previously mentioned findings. Thus, the effect of repayment flexibility on fiscal discipline of the poor consumer receives mixed empirical support from the existing literature. Further, there remains a real possibility of increased operating costs from administering and monitoring flexible contracts which may put an upward pressure on the already high interest rates (approximately 22 per cent per annum) which the MFIs charge. While Karlan and Mullainathan (2006) suggest an easily administrable token system to account for rescheduled repayments, Banerjee and Duflo (2011) suggest something more fundamental: they highlight the undue attention MFIs provide to the repayment rate which is widely considered as the hallmark of success for micro finance in general and present a need for conceptualizing new business models built around other measures of success. In this context, there remains a scope for an alternative business model based upon providing flexible financial products to the poor in a sustainable and profitable manner, without moving away from the core welfare objectives at the heart of such institutions. Such a model will necessitate MFIs to work more closely with their consumers while moving away from the prevalent one-size-fits-all strategy of offering vanilla products to everyone. This will eventually pave the way for the much-needed customized financial products designed by keeping in mind the idiosyncratic needs for credit (e.g., credit needs depending on the characteristic cash flows of the enterprise the poor consumer has invested in or cash flows before and after the harvest season) of their consumers.

Conclusion

This article presents a discussion on the benefits of offering flexible micro loans and flexible financial products in general versus rigid products to the underprivileged consumers based on the psychological underpinnings of decision making among the underprivileged. In doing so, the article underscores the role flexibility in loan contracts plays in attaining the dual welfare objectives of poverty alleviation: economic welfare of the poor and their psychological well-being.

It is, however, very essential to garner empirical evidence in support for the ideas thus presented in this article. Research designed to gather such evidence should involve both laboratory experiments and field studies, keeping in mind the significant challenges faced by psychologists in uncovering the psychological processes in decision making, and the overarching need to establish the generalizability of the findings for studies with the potential of impacting policy making. Further, studies should be conducted to compare and test the efficacy of financial products differing in their degree of flexibility (e.g., micro loans with pre-determined periods of lower repayment amounts versus micro-loans allowing the consumer to choose the periods at which to make lower repayments).

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