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Misconceptions about the Credit, Savings And Loan Repayment Behaviour of the Poor: A Review

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Abstract

The directed agricultural credit approach was based on the erroneous assumptions that smallholder farmers use loans exclusively for short-term consumption, are not creditworthy, and are too poor to save and to self-finance the required investments in additional farm inputs. These misconceptions were at the expense of mobilization of domestic deposits and savings, the creditworthiness of the borrower, good loan recovery, and long-run institutional viability. Recent socio-economic researches have shown that many of these assumptions about the poor are neither substantiated nor correct. This paper reviews some of the misconceptions about the poor and uses evidences and other relevant information from studies to show that these misconceptions are disprovable.

Keywords: *Credit, savings, behaviour, the poor, misconceptions.*

Introduction

Poor people need and use a broad range of financial services, including loans, deposits, and other services. They use financial services for the same reasons as anyone else: for consumption smoothing, external and self-financing of economic operations, accumulation and safe keeping of their savings, risk management, social security and loan protection (IFAD, 2000; IFAD, 2001; Littlefield and Rosenberg, 2004).

Regrettably, however, poor people, especially women, commonly have limited access to financial services, so donors and national governments have invested substantially in developing financial services for the poor. According to Holt and Ribe (1991), most of these efforts have been large-scale, formal, regulated programmes emphasizing more rural credit to poor farmers, usually at below-market interest rates. The underlying premise of these programmes has been that market interest rates are too high and that reducing them would make credit more accessible to poor people. But experience with regulated credit has taught valuable lessons. One is that distortionary macroeconomic and regulatory environments hinder development of the financial sector and do not improve the poor's access to credit. Another is that subsidized, targeted credit cannot reduce poverty without adequate markets and infrastructure (Holt and Ribe, 1991). This has necessitated a shift away from subsidized credit towards developing a new generation of financial service programmes for poor people which

emphasize the provision of adequate financial services on a sustainable basis to all segments of the population.

Though much of rural financial policy until the end of the 1980s was based on the faulty premises that the poor in developing countries are neither creditworthy nor are able to save, recent socio-economic research has shown that these common assumptions are unfounded. The new consensus that has emerged is that many of the poor can save, invest, and repay their loans.

This paper reviews some of the common misconceptions about the poor and the emerging evidences disproving these misconceptions.

The Misconceptions (Myths) About the Poor

Some of the misperceptions about low-income households which formed the basis for directed agricultural credit programmes are that the rural poor:

(i) lack collateral for obtaining credit
(ii) use loans for consumption rather than investment
(iii) cannot save and therefore will not respond to incentives or opportunities to save
(iv) use savings exclusively for short-term consumption
(v) cannot pay market interest rates on loans and therefore need cheap loans before they will adopt new technologies and make major farm investments
(vi) are credit risks and therefore unable to repay loans
(vii) are not risk averse
(viii) use loans in kind in the form granted (Vogel, 1984; Adams and Graham, 1984; Levitsky and Prasad, 1990; Holt and Ribe, 1991; Braverman and Huppi, 1991; Besley, 1994; Fiebig, 1999; Zeller, 1999; Klein *et al*., 1999).

Evidences Disproving the Misconceptions

Though data on poor people's behaviour with credit and savings are scarce, examples from recent experiences and studies do counter these misconceptions or myths about the poor. These are as discussed below:

Lack of collateral for credit: Most poor people lack the kind of marketable collateral necessary for obtaining traditional bank loans. For example, land is the most widely accepted asset for use as collateral because it is fixed and not easily destroyed. It is also often prized by owners above its market value and has a high scarcity value in densely populated areas (Klein *et al*., 1999). Smallholder farmers with land that has limited value, or those who have only usufruct rights, are less likely to have access to bank loans. The concept of agricultural warrantage has, however, helped more poor people to secure bank loans and get better prices for their produce. Under warrantage, farmers leverage their produce inventories for credit. Instead of selling their produce immediately after harvest – when prices are lowest – to generate financing for the

following season, farmers store their harvest and use it as a collateral for bank credit. The produce is stored in locked warehouses secured by banks, which then extend credit based on the value of the stored harvest. Farmers can use the up-front bank finance to purchase inputs for the next season while also storing their harvests until deep into the off-season when produce scarcity boosts prices. When the stored produce is marketed at off-season prices, farmers can use the proceeds to pay off the banks and retain any remaining earnings as profit (IMF, 2010). Also, titles of occupation, as introduced in Nigeria, or very long leases, as tried in Tanzania, can give farmers the security they need to undertake long-term investments on land. These documents can also serve as collateral for loans (Harrison, 1990). For moveable assets such as livestock and equipment which are regarded by lenders as higher risk forms of security, owners that endeavour to provide proof of purchase and have insurance coverage on these items make them more acceptable as collaterals. Most microfinance institutions also rely upon some form of collateral substitute to ensure repayment of loans by poor borrowers. These collateral substitutes generally fall into one of two categories:

(a) Group lending, by which borrowers form (or are assigned to) groups, all of whose members must maintain a satisfactory payment record for any group member to be eligible for future loans; or

(b) Character and/or experience-based individual loans, by which, typically, the initial loan requires a character reference from a village chief or other persons with a stake in maintaining a reputation for probity and sound judgement. Initial loans are very small but access to gradually increasing loans is assured as long as the borrower maintains a satisfactory repayment record (USAID, 1994).

Use of loans for consumption: One common perception is that borrowers use loans for consumption rather than production. Lenders are especially concerned about this because it may reduce the likelihood of repayment. But evidence from studies of low-income credit strongly suggests that, except for the ultra-poor whose subsistence position forces them to use whatever cash they have for consumption, credit is commonly used for productive investment. For example, survey data from the Grameen Bank credit programme in Bangladesh show that client loans are used mainly for productive purposes. Most funds went for productive uses for both male and female borrowers (Table 1). Also, a survey of informal lenders and borrowers in the Philippines revealed that 48 percent of small farmers did not use informal credit for consumption (Von Pischke, 1989).

Table 1: Patterns of Loan Use by Gender of Borrower in Bangladesh.

	(Percentage of Current Loan Amount)		
Use	Men	Women	All
1.1 Nonproductive	4.9	8.1	6.6
Consumption	0.5	0.9	0.7
Social ceremony	3.5	5.0	4.3
House repair	0.9	2.2	1.6
Productive[a]	95.1	91.9	93.5
Crop cultivation	7.4	5.5	6.4
Livestock raising	19.9	33.1	26.8
Poultry raising	3.9	5.7	4.9
Processing and manufacturing	11.6	18.3	15.1
Trading and shopkeeping	43.7	27.3	35.1
Transport and other services	8.7	2.1	5.2

a. Production figures do not add up exactly because of rounding.
Source: Hossain (1988).

Poor people do not save: The assumption has been that poor people, because they are poor, do not save, hence few programmes have promoted deposit facilities. But there is evidence that the poor do save in informal financial markets and in other liquid and illiquid assets. They save to smooth consumption by building up stocks of grain seasonally and running them down when the harvest season is over (Holt and Ribe, 1991). Thus, savings are crucial to straddle the period between two successive harvests and to meet contingency expenditures. Household savings can therefore be used for a variety of production, investment and deferred consumption purposes. These include conserving seeds, purchasing new farm inputs, storing of crop produce for deferred consumption and/or selling off later in the season at more lucrative market prices (Klein *et al*., 1999). The poor also possess durable assets such as household tools, jewelries, and draught power which can be sold in times of crisis (drought or flood) and then re-purchased (Bell, 1989). Recent research also indicates that given opportunities and incentives to save, poor people can save far more than previously thought (Adams and Graham, 1984; Otero, 1989). For example, a Rural Savings Mobilization Project in the Dominican Republic clearly demonstrated the rural demand for deposit services (Gonzalez-Vega, 1988). Under this project, sponsored by the United States Agency for International Development (USAID), the Banco Agricola (BA), a public agricultural development bank with 31 branches scattered about the countryside, set up passbook savings account facilities. Pessimists doubted that low-income rural households would save, but the pilot project initiated in 7 branches, grew rapidly. The number of term

deposits rose from 2,628 in 7 branches in 1984 to 66,570 accounts in 31 branches in 1987. Moreover, 40 percent of the depositors were new clients for the bank, who demanded only a safe and convenient means of managing their liquid assets (Holt and Ribe, 1991). This demand for savings has been documented in other regions as well. For example, since the introduction of the SIMPEDES programme (the saving scheme associated with the Unit Desa system of the Bank Rekyat Indonesia, BRI), the Unit Desa's savings have grown faster than its lending. By 1989, BRI was able to fully finance its village lending activities from locally mobilized savings. Since then, the growth of savings has outpaced that of loans, testifying to a strong demand by the rural poor for deposit services. By 1999, its 3700 rural sub-branches had 2.5 million active borrowers and some 20 million savings accounts (Seibel, 2000). Even at the peak of the Asian financial crisis between June and August 1998, demand for credit stagnated because of a general lack of confidence in the future, but BRI attracted 1.29 million new savers during the three-month period, leading to increases in the volume of savings deposits in both nominal and real terms (Seibel, 2000; Seibel, 2001).

Use of savings for consumption: Poor people's savings are not used exclusively for short-term consumption. Though data on savings are more scant than data on credit, the few studies that have been done suggest that savings are used for long-term investment and welfare (Holt and Ribe, 1991). In her study of savings patterns among low-income women at a tea plantation in Cameroon, Delancey (1983) found that low-income female wage earners used 45 percent of their savings for security and welfare (retirement or sickness), and 36 percent for investment and development, especially for education. Consumption appeared to be a relatively low priority, accounting for only about 19 percent (Table 2). Self-employed poor people also use their savings for productive investment. For example, studies of savings mechanisms in Ghana's informal sector found that small-scale traders and vendors rely heavily on indigenous money collectors to save working capital for their enterprises (Gabianu, undated). Similarly, in a savings programme in Zimbabwe, female farmers used their savings to purchase fertilizers and other farm inputs (Bratton, 1990).

Table 2: Women's Reasons for Saving at Tole Tea Estate in Cameroon.

Reason	Number	Percentage of reasons[a] (N=370)	Percentage of savers[b] (N=171)
Social security or welfare	170	44.9	--
Trouble or sickness	88	23.3	51.5
Transport home	6	1.6	3.5
Funeral	15	4.0	8.8
Unemployment or retirement	30	7.9	17.5
Future plans	6	1.6	3.5
Bequest to children	18	4.7	10.5
Family assistance	7	1.8	4.1
Investment or development	138	36.4	--
Education	89	23.5	52.0
Help children get employment	5	1.3	2.9
Help children get ahead	2	0.5	1.2
Business	6	1.6	3.5
Farm	1	0.3	0.6
Corn mill	3	0.8	1.8
Engine saw	2	0.5	1.2
Rental structure	3	0.8	1.8
Own house	20	5.3	11.7
Taxi	7	1.8	4.1
Consumption	71	18.8	--
Food and clothes	18	4.7	10.5
Maintenance of children and self	23	6.1	13.5
Durable assets[c]	10	2.6	5.8
Durable and sewing machines[d]	(17)	(4.5)	(9)
Autos	4	1.1	2.3
Bridewealth	4	1.1	2.3
Enjoyment	4	1.1	2.3
Other	1	0.3	0.6

a. The number citing each reason as a percentage of the number of all reasons cited.
b. The percentage of savers giving each reason.
c. Bicycles, radios, pots and pans, iron beds.
d. Sewing machines purchased for personal use or investment.
Source: Delancey (1983).

The poor cannot pay market loan rates: Another misconception is that rural people are unable to pay market interest rates for credit. The rationale for providing credit at below-market rates is undermined by evidence that the poor are willing to pay market interest rates. For example, a study of rural financial markets in Bangladesh which experimented with lending at annual interest rates ranging from 12 percent to 36 percent, found that small farmers' demand for loans remained relatively inelastic up to

an interest rate of about 30 percent (USAID, 1983). Moreover, poor people borrow routinely on the informal market, where interest rates have historically exceeded formal market rates. Thus, low-income people prefer to sustain durable relationships with informal lenders who can provide timely access to small loans. This is supported by Braverman and Huppi (1991) to the effect that the price of loans is a relatively unimportant factor in inducing farmers to borrow, and that much more important are timely services and simple application and disbursement procedures. The United States Agency for International Development (1994) also notes that the rapid growth in demand for small loans at fully cost-covering interest rates, with repayment rates as high or higher than those in formal financial markets, suggests that most poor people value continued, reliable access to credit and other financial services more highly than interest rate subsidies on a few short-term loans.

The poor as credit risks: Another myth implicit in the few loans given to the poor, particularly women, in developing countries is that they are credit risks. But evidences from credit programmes with heavy female participation have found this not to be true. In their study of women's credit in Bangladesh, Hossain and Afsar (1989) found that programmes that focus on women have higher repayment rates than traditional credit schemes that have excluded women. At Grameen Bank in Bangladesh with between 84 and 91 percent female membership and at Badan Kredit Kecamatan (BKK) in Indonesia with 60 percent female membership, loan collection rates range between 80 and 98.6 percent (Yaron, 1995). Managers of these two institutions argue that they purposely target women borrowers because they are more disciplined and more careful with capital (Hossain and Afsar, 1989). Also, two of the best savings and credit programmes in India – the Self-Employed Women's Association and the Working Women's Forum, both with 90 to 95 percent repayment rates – are women's programmes. The Foundation for the Promotion and Development of Microenterprises (PRODEM) in Bolivia has more than 10,000 borrowers, 77 percent of whom are women. After 4 years of operation, repayment rates remained above 99 percent (Holt and Ribe, 1991). The point being made here is that the poor are creditworthy.

The poor are not risk averse: Research has shown that low-income producers tend to be risk-averse and conservative in their decision-making (Hazell *et al*, 1986). They cope with risks by diversifying their household income from farm and non-farm activities. Small farmers save in various forms, accumulate physical assets and participate in networks defined by social relations and mutual aid arrangements (Klein *et al*., 1999). An analysis of the cash flows of low-income rural households indicates that an often complex interdependency exists between the farm and the family household. Non-farm activities may account for a large share of the farm household income in rural areas (Klein *et al*., 1999). Non-farm employment has an important

function by generating earnings that are used as working capital, or savings. In the case of poorer households, they are an income source for survival during hungry seasons. The fact that agricultural planners used to focus their attention on efforts to increase food production meant that they failed to recognize the importance of non-farm income sources for small farm households. Consequently, credit programmes did not consider the effects of diversified and off-farm income-generating activities on the overall farm household net cash flow. Planners under-estimated the capability of farmers to self-finance their returning investment requirements and to repay their loans (Klein *et al*., 1999).

Use of loans in kind in forms granted: It is commonly recommended that loans to be used for inputs such as fertilizers, pesticides, and improved seeds should be given in kind rather than in cash. The reason being that loans in kind encourage the use of the items being supplied and make it less likely that the loan will be diverted to other uses (Miller, 1975). However, tied loans may not prevent farmers from selling the inputs and using the proceeds for what they may consider to be more profitable uses or for consumption (Miller, 1977). Besides, farm households are integrated production and consumption units such that farm household and farm business finances are intertwined. As a result, efforts to restrict the use of funds to specified business purposes are typically futile and counterproductive (USAID, 1994). For example, due to the fungibility of money, borrowers could use savings to purchase livestock and loans to finance a wedding. Also, borrowers may use the loan to meet immediate debt payment or consumption needs, yet still manage to organize the resources needed to invest in a productive activity that enables them to make timely payments. As long as the household's financial management permits repayment, the actual use of the loan may not be important (Holt and Ribe, 1991).

Conclusion and recommendations

The directed credit approach in the past was based on the misconceptions that the poor do not save, invest and repay their loans. Past policy, therefore, neglected to provide for savings and insurance services and concentrated on giving loans. In recent times, however, the poor have demonstrated that they can save or borrow and invest their funds profitably. The recommendations for this paper are:

(i) The recognition of the existence of rural savings and the need to grant loans for rural farm and non-farm activities means that appropriate savings deposit facilities and diversified loan products are required. Their provision would serve to strengthen rural financial intermediation and satisfy the effective demand for different types of financial services.

(ii) To provide financial services to the poor reliably and cost-effectively will entail mediating between savers and investors, widening and deepening financial services to the poor, and lowering transaction costs. Financial deepening involves eliminating distortionary financial policies and practices and establishing greater efficiency in the mobilization and allocation of resources.

(iii) Microfinance programmes for the poor must ensure that their services are well-adapted to the particular requirements of their potential clients. This means that clients should generally be able to choose which services they need rather than being offered a fixed package of financial and non-financial services on a take-it-or-leave-it basis. In this regard, systematic market research to help guide this process of adaptation will be the hallmark of serious programme management.

(iv) Given the diversity of income sources upon which the poor depend and their need for both production and consumption credit as well as savings outlets, it is apparent that multi-purpose financial institutions would be more useful than specialized savings or lending institutions.

(v) Giving the poor wider access to savings and credit services requires institutional growth. Group formation appears to be the best and most sustainable way of achieving low transaction costs, accountability and efficiency. Braun (1992) has argued that support of group formation and training (in savings mobilization and loan management) during the early stages should not be viewed as a subsidy, but as an investment that creates institutional capital.

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