J-PAL
ABDUL LATIF JAMEEL POVERTY ACTION LAB

Flexible Loan Contracts for Microentrepreneurs in Bangladesh

Researchers:

Marianna Battaglia

Selim Gulesci

Andreas Madestam

Sector(s): Finance

J-PAL office: J-PAL South Asia

Location: Bangladesh

Sample: 2,717 eligible borrowers

Target group: Entrepreneurs Small and medium enterprises

Outcome of interest: Earnings and income Business investment Credit balance/repayment

Intervention type: Credit Contracts

AEA RCT registration number: AEARCTR-0002892

Partner organization(s): BRAC, International Growth Center (IGC), Private Enterprise Development in Low-Income Countries (PEDL)

Lack of access to credit and insurance markets can prevent small-scale firms in low- and middle-income countries from making profitable investments. In Bangladesh, researchers partnered with BRAC to evaluate the impact of repayment flexibility in loan contracts for microentrepreneurs. Repayment flexibility benefited traditional microfinance borrowers primarily through the provision of insurance, enabling riskier investments at lower default rates.

Policy issue

In low- and middle-income countries, entrepreneurs are sometimes prevented from making profitable investments by lack of access to credit and insurance markets. While improved availability of credit and insurance might help aspiring entrepreneurs, existing evidence shows that conventional microcredit has not generated substantial firm growth on average. One possible solution is to provide repayment flexibility in loan contracts, which eases the constraint on credit as it allows for increased spending during the startup phase, and provides insurance, in case of fluctuations in income. Can repayment flexibility in loan contracts improve the business outcomes and socioeconomic status of traditional microfinance clients in Bangladesh?

Context of the evaluation

In Bangladesh, BRAC is one of the main providers of microfinance services. This study focused on two microfinance products offered by BRAC: the “Dabi” loan and the “Progoti” loan. The Dabi loan is meant to finance microenterprises (e.g., tailoring, small retail shops, poultry and livestock rearing, etc.) that typically have no employees except for family workers. The average size of a Dabi loan is US$275, with a range between US$100-US$1,000. At the time of this study, BRAC had four million Dabi borrowers in Bangladesh.

BRAC also offers the larger Progoti loan for small- and medium-sized enterprises. The Progoti loans are intended for working capital in shops, agricultural businesses, and small-scale manufacturers and have an average size of US$2,200 (with a range between US$1,000-US$10,000). Compared to the Dabi loan, the Progoti loan requires collateral of equal value to the loan and a guarantor. Both Dabi and Progoti loans have a 22 percent annual interest rate, individual liability, and a twelve-month repayment cycle with equal monthly installments.

The average eligible Dabi client in this study was 38-39 years old, had 4.5 years of schooling, and approximately half owned some land. In contrast, the Progoti clients were older (44 years old), more educated (7.5 years of schooling), and wealthier (83 percent owned land). The annual average household income of Dabi clients was about US$7,000, while Progoti clients earned more than US$20,000 per year. Forty-five percent of Dabi clients reported having businesses, whereas 87 percent of Progoti clients were business owners.

Details of the intervention

In collaboration with BRAC, researchers conducted a randomized evaluation to measure the impact of repayment flexibility in loan contracts.

The flexible loan contract offered by BRAC allowed borrowers to delay up to two repayments within their loan cycle through the use of repayment vouchers. On the day a payment was due, borrowers could present the voucher to postpone the repayment and extend the loan cycle. BRAC offered the option to borrow under the flexible contract to Dabi and Progoti clients with good credit histories.

Out of fifty branches identified by BRAC, researchers randomly selected 25 to introduce the flexible loan. The remaining 25 branches served as the comparison group where the new loan product was not introduced. Immediately following the launch of the flexible loan in intervention branches, researchers collaborated with BRAC to implement an information campaign to ensure that information regarding the new loan reached eligible borrowers.

Researchers surveyed participants between January and June 2015, prior to the launch of the flexible loan product in mid-August 2015. They surveyed participants eight to ten months after the flexible loan product was introduced (between May and July 2016), and again one year later. Researchers also received administrative records from BRAC on its borrowers, which contained data on borrowers' repayment behavior.

Results and policy lessons

Repayment flexibility benefited traditional microfinance borrowers primarily through the provision of insurance, enabling riskier investments at lower default rates.

Repayment flexibility improved the business outcomes and socioeconomic status of Dabi clients, without raising the default rate. The introduction of repayment flexibility increased borrowing by Dabi clients by 6.3 percentage points, an 11 percent increase from the comparison group average of 57 percent. Dabi clients offered repayment flexibility generated 86 percent more revenue and had 27 percent higher monthly profits than clients in the comparison group. In terms of socioeconomic status, Dabi clients offered repayment flexibility had higher household income, more non-business assets, and owned more land than borrowers in the comparison group. Dabi borrowers who were offered repayment flexibility were 1.7 percentage points less likely to have not repaid their loan by the end of the loan cycle, or 35.4 percent less than the comparison group default rate of 4.8 percent.

On the other hand, researchers found no meaningful effects among Progoti borrowers offered repayment flexibility in terms of business or household outcomes on average and their borrowing or repayment behavior. The impact of repayment flexibility on the default rates of Progoti clients was close to zero.

To better understand whether repayment flexibility alleviated the microentrepreneurs' credit constraints or their insurance constraints, researchers examined whether the flexible contract increased risk taking among borrowers. First, they found that Dabi clients experienced higher sales volatility, which suggests that repayment flexibility led microentrepreneurs to take greater risks. Second, among the Dabi clients who were offered the repayment flexibility, the increase in revenues and profits was experienced primarily by business owners in areas where the demand for business was more uncertain at the beginning of the study. Third, Dabi borrowers who were offered the repayment flexibility also experienced an increase in profits and revenues only in areas where there was favorable rainfall, suggesting that clients had shifted to activities that were more susceptible to uncertainty in the local markets. Finally, Dabi borrowers who were offered the repayment flexibility increased their illiquid business assets, such as special-purpose tools and machinery, which are sensitive to overall uncertainty in the markets. These findings imply that repayment flexibility served for microentrepreneurs as a form of insurance that enabled them to make riskier investments, and ultimately led to favorable business outcomes, socioeconomic impacts, and lower default rates.

Taken together, these results demonstrate that repayment flexibility provides a simple but novel way to spur risk-taking and entrepreneurship among low-income people.

In a separate project, Gulesci and Madestam, together with Francesco Loiacono and Miri Stryjan, are investigating the long-term importance of repayment flexibility in Uganda in cooperation with BRAC.