MICROFINANCE CENTRE

Over-Indebtedness Prevention

22nd June 2016, Tirana, Albania

Workshop objectives

- To learn about good practices related to over-indebtedness prevention
- To learn about data which can help analyze and reduce risks of over-indebtedness
- To understand what factors can contribute to over-indebtedness

What is overindebtedness?

The Simple Answer:

Overindebtedness is when clients have more loans than they can afford

The Complicated Answer:

Is more complicated…

MICROFINANCE CENTRE

How to identify overindebtedness

Sacrifice approach

- Borrower is continuously struggling to meet repayment deadlines and structurally has to make unduly high sacrifices related to his/her loan obligations" (Schicks, 2010)

Net indebtedness index (NII) approach

- Borrower total debt service is higher than his/her net income during a defined timeframe, whether it is from one or multiple loans" (Cambodia Over-indebtedness study 2013)

Default/delinquency approach

- A microfinance client is over-indebted if he/she can not repay the loan.

MICROFINANCE CENTRE

Overindebtedness – why it is important?

- While other violations of client protection principles hurt clients, overindebtedness is the only one that caries direct systemic risk.
- It risks destroying the entire financial system
- Prevention of overindebtedness is the Smart campaign’s second principle (of seven total)

the smart campaign

MICROFINANCE CENTRE

International Standards to prevent client over-indebtedness

- The FI has a sound policy and well-documented process for loan approvals and makes decisions using appropriate information and criteria.
  - incorporate a sensitivity assessment into the application – stress test for loans in USD
- The FI uses credit reporting information, when feasible in the local context.
- FI senior management and board monitor the market and respond to heightened over-indebtedness risk.
- The FI maintains sound portfolio quality.
- The FI incentivizes staff to approve quality loans.

the smart campaign
Keeping clients first in microfinance

MICROFINANCE CENTRE

Transparency vs. Currency risks

- Communicate currency risks to client
  - Interest rates for indexed loans may create confusion in clients minds by appearing lower than they are
- Do not promote indexed loans as cheaper than local currency loans.


Definitions

What is an exchange rate?
An exchange rate is the price you pay for a foreign currency. Exchange rates are affected by several aspects out of your direct control, like money supply, trade balance, inflation, speculation. These exchange rates are unpredictable. The number of Leu needed for one Euro can suddenly increase or decrease.

What is a Foreign Exchange (FX) Loan?
A loan denominated in a foreign currency, such as Euro, Dollar or Swiss Franc.

Repayment:
Your monthly payments to the bank are in Euro. If you don't have an income in Euro, you need to convert Leu into Euro each month.

What is an FX indexed loan?
A loan denominated in Leu but tied to a foreign currency, such as Euro, Dollar or Swiss Franc.

Repayment:
Your monthly payments to the bank are in Leu. However, when the exchange rate between the Leu and the foreign currency changes, your monthly payments in Leu are also affected.

Note that in this brochure all examples are made under the assumption of fixed interest rates.

FX Loans: Five important considerations

A foreign exchange loan is a risky product. The best way to avoid the risks is taking a loan in local currency. If you do decide to take a foreign exchange loan, do consider the following:

1. Don't blindly focus on interest rates.
   Often, foreign exchange loans have lower interest rates than loans in local currency. But remember that interest rates are just one side of the story. Increasing exchange rates may affect your monthly payments.
2. Be prepared for unpredictable exchange rate changes.
   Do not count on the exchange rate to remain stable as it will not! No one – not even banks – can predict future exchange rates.
3. Borrow sensibly.
   Make sure you can afford your monthly payments to the bank, even if the local currency drops for example by 20% or more. Use the calculator inside this brochure.
4. Foreign exchange income is not a guarantee.
   An income in the same foreign currency as the foreign exchange loan reduces your risk. If exchange rate fluctuations cause an increase of your monthly payments, the same fluctuations lead to increased foreign exchange incomes. But, a foreign exchange income (for example sent by family members abroad) is often not a stable source of income. Ask yourself whether you want to rely on these incomes for repaying your loan.
5. Don't take a foreign exchange loan if you do not understand the risks.
   In this brochure the exchange rate risk is explained. If you do not understand this completely, please do not hesitate to ask for more information.

Sponsored by:
EFSE

A Foreign Currency (FX) Loan?

Make sure you understand the risks!

FX loans: know what you borrow
Loans denominated in Euros, Dollars, Swiss Francs or another foreign currency often seem attractive, as interest rates are usually lower than loans in your local currency. However, these loans are risky: your monthly payments can increase when the exchange rate changes.
Are you considering taking a foreign exchange loan? Please read this brochure to understand the risks of foreign exchange loans. As an introduction you will find some basic terms and definitions below and opposite.

Banks offer FX loans
You can take a loan from the bank in your local currency. But banks also offer loans in foreign currencies (FX loans) or loans that are tied to foreign currencies (FX indexed loans).

Monthly payment: principal and interest
Your monthly payment consists of two elements: the principal payment, being the repayment of the original sum of money that you borrowed, and the interest, or the costs of borrowing money, often calculated as a percentage of the amount borrowed.

Risks of FX loans
Often, banks charge lower interest rates for FX loans. But, these loans may not always be cheaper! For FX (indexed) loans, your monthly payments in local currency depend on the exchange rate between your local currency and the foreign currency.
The exchange rate between the local currency and the Euro, Dollar or Swiss Franc is unpredictable.
Therefore, the monthly payments of an FX (indexed) loan are also variable. If your local currency devaluates, you need more money to repay your monthly installments. These increased monthly payments may even be higher than your monthly income.

If you take a loan in your local currency, your monthly payments are fixed. The monthly payments of these loans do not depend on the exchange rate.

You will find more information inside this brochure, with practical examples and a tool to help you calculating your FX risks.

EFSE FXlending_folder_105x240mm_3.indd 1-4

MICROFINANCE CENTRE

Cash-flow tool

Monthly cash-flow

Cash-flow in AMD	
Cash inflows in AMD	20 000 000 AMD
Cash outflows in AMD	16 000 000 AMD
Net AMD cash-flow	**4 000 000 AMD**
cash-flow in USD	
Cash inflows in USD or indexed in USD	3 000 USD
Cash outflows in USD or indexed in USD	1 000 USD
Net USD cash-flow	**2 000 USD**
Additional cash outflow in USD for planned new USD loan	8 700 USD
New monthly net USD cash-flow	**-6 700 USD**
Impact on your cash-flow - current fx rate	

Fill in the light blue cells with your own monthly business data and the tool will calculate the impact of taking out a USD loan on your monthly liquidity situation. Please remember that you incur a high risk if you have to convert more than 70% of your net monthly AMD cash-flow to USD to cover your foreign currency liabilities.

MICROFINANCE CENTRE

Currency risks – preventive measures at MFI

- Risk Fund – FI should have a fund to cover the costs related to risks which appears
- Have e dollar-based deposits at commercial banks in the country
- Structure loan repayments so the cash receipts of borrowers can be quickly converted back into dollars.
- Use hedge products (if exists)
- Balance foreign currency liabilities with foreign currency assets.

MICROFINANCE CENTRE

Currency risks – preventive measures at MFI

- Diversify portfolio: local and USD loans
- Track and monitor foreign exchange risk at the MFI level.
- MFIs <u>should not </u>pass on foreign currency risk to borrowers who are not earning revenues in that foreign currency.

MICROFINANCE CENTRE

Microfinance Centre
Noakowskiego 10/38
00-666 Warsaw, Poland

Tel./Fax: +48 22 622 34 65
kdabrowska@mfc.org.pl
www.mfc.org.pl

Thank you!