



Over-indebtedness in Mexico: Giving Borrowers a Voice

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Acknowledgements

The Microfinance CEO Working Group requested this study in order to investigate the scale of over-indebtedness in Mexico and its root causes. The research was designed and executed by the authors in collaboration with FINCA staff, whose contribution we gratefully acknowledge. Data collection was supervised by Julian Diaz-Peralta and Katie Torrington. Carol Gardner assisted with early drafts. We would like to thank Rupert Scofield, Soledad Gompf, Luis Camacho and Bijan Osburg in particular for their support.

Summary and Main Findings

FINCA and our colleagues in the socially responsible lending community are anxious to avoid a debt crisis in Mexico, similar to those that have caused major upheavals in other countries. We engaged with staff in our Mexican subsidiary to study this problem, with the aim of establishing some of its dimensions and uncovering the client pathways to debt.¹ Our research combined three methods: a review of credit bureau data from a pool of loan applicants, a survey of branch managers, and qualitative interviews with borrowers themselves, most of whom were experiencing or had experienced debt problems.

In the credit bureau data, we found a high prevalence of new FINCA applicants having existing loans (about 74 percent), many of these with multiple accounts in arrears. Fully 60 percent of those with two outstanding loans were found to be in arrears, with the number rising to 80 percent of those with four sources of credit. Reflecting this situation, branch managers report that it is increasingly difficult to find *qualified* borrowers – people whose existing debt burdens would not impair their ability to repay new loans. They also paint the picture of a highly competitive and growth-driven marketplace in which bad practices are

¹¹ The Working Group also commissioned a companion piece, *Over-indebtedness: A Risk-Management Approach*, which is discussed later in this paper.

commonplace, such as credit promoters disseminating false information about rival lenders, giving incentives to clients for agreeing to loans on the spot, and even delaying credit reports so that a paid-up client is unable to obtain credit elsewhere. Managers also report that most borrowers have little understanding about the actual terms of their existing loans.

Our discussions with borrowers unveiled various pathways to over-indebtedness, none of which are new. Lacking savings or other assets, our interviewees use credit to finance a wide variety of productive pursuits and to deal with family contingencies, such as the death of a family member or a medical emergency. At the same time, they are pressured to help out needy members of the extended family. Passing along loan proceeds to a relative who does not qualify for credit, they are left to deal with the consequences when the money goes unpaid. While some borrowers readily admitted that they were tempted to live beyond their means, most of the purchases, such as school uniforms, could hardly be considered extravagant.

Regardless of what had gotten them into trouble, the over-stretched borrowers we interviewed were determined to settle their accounts with their creditors and were making every effort to do so, even when they felt that they had been taken advantage of. Rather than walk away from their obligations, they were doing what they could to pay off their loans, perceiving that continued access to credit will continue to be important for their future endeavors. This behavior extends to the members of peer lending groups, who go so far as to absorb the debts of defaulting members in order to continue accessing credit.

If profligate behavior is leading to a crisis of over-indebtedness, then, it is on the part of lenders. Spurred in part by the relaxation of oversight in 2006, the number and variety of creditors, along with the total volume of loans, have increased massively.² It is safe to assume that most lenders are profiting under current conditions. On one hand, we find a vast pool of potential borrowers who have very pressing needs for money, and who will go to great lengths to settle their debts. On the other, an eager throng of creditors, both commercial and non-profit, willing to make loans with little regard for the borrower's financial situation. An institution with proper credit discipline would avoid making risky loans because of the costs they incur, including written-off principal, lost income, and extra administration. But in Mexico, creditors are successfully pushing the costs of their reckless loans onto the borrowers themselves. With customers paying the price, bad lending seems to be good business – for the time being, at least.

² We refer to the changes in banking legislation which created a new type of lending entity in Mexico, called the *Sociedad Financiera de Objeto Múltiple*, or SOFOM. An unregulated SOFOM does not have to report to the National Banking and Securities Commission, nor does it have capital or reserve requirements.

To avoid a likely crisis, lenders ought to act voluntarily and soon. They should curb their appetite for unrestrained growth in favor of a more sustainable approach, one that is concerned with the needs and capacity of their customers and with building a high-quality loan portfolio on the basis of sound credit discipline. Rather than proliferate bad loans at the borrower's expense, lenders (both for-profit and non-profit alike) should make a clear statement of honest intent by publicly committing to the Client Protection Principles as articulated by the Smart Campaign, and submitting to external verification of their compliance.³ In shifting the focus from growth to quality, lenders will also need to review the internal incentives that are propelling both staff and clients towards irresponsible credit decisions.

Sustainable lending begins with a careful assessment of a prospective borrower's financial situation – including his or her family circumstances – prior to approving a loan. At the same time, the lender should ensure that the borrower fully understands both the loan terms and its impact on her cash flow. Given that this cash flow is often irregular, especially for self-employed individuals, some measure of flexibility would help to match the borrower's obligations with her capacity to repay. This is especially true when a borrower is under duress, and finds herself driven to migrate from creditor to creditor in order to avoid default.

This course of action can be pursued by any lender that is seriously committed to the welfare of its clients. However, it is important for these changes to be implemented by a broad range of creditors, including both for-profit and non-profit institutions. Socially-responsible microfinance institutions (MFIs) might implement the Client Protection Principles, but what about retail creditors and payday lenders? Therefore, in addition to the voluntary actions by lenders, it is important for regulators to step-in to protect the public's interest in a financial system that is sustainable, inclusive, and that enhances rather than weakens the economic prospects of the poor.

We are not experts in banking regulation and therefore leave the specifics of this recommendation for debate by others who know the topic well, and who can draw from the positive and negative experiences of other countries, such as India and Nicaragua, where over-indebtedness has spurred government action. Official intervention is powerful and should not come at the cost of financial inclusion. But the experiences of our interviewees suggest that there is significant scope for elevating the government's role in a number of areas, including educating the public, providing means for redress, and ensuring that credit providers adhere to minimum standards of credit discipline. The strengthening of credit discipline, in particular, seems all the more urgent in light of recent legislation which is

³ The Smart Campaign promotes a self-assessment by lenders, as well as an external certification process whereby lenders can gain an independent verification of their adherence to the Client Protection Principles.

likely to considerably accelerate the flow of credit to the low-income sector.⁴ In the absence of such measures, borrowers – especially those whose lives are precarious to begin with – are exposed to the whims of a growing market that not only fails to deliver on the promise of financial inclusion, but which actually makes their climb out of poverty even steeper.

Introduction

Over-indebtedness occurs when a borrower has more debt than he or she can reasonably repay, given income, savings and assets. As the sheer volume and varying forms of credit are increasing in Mexico and other countries, there is evidence that over-indebtedness poses a substantial challenge for lenders and borrowers alike. Debt repayments start to consume a disproportionate share of borrowers' available resources, leading to arrears, additional collection costs and high default rates. For regulated institutions, a deteriorating portfolio can trigger higher reserve and provisioning requirements, straining their solvency. Given such consequences, it is no surprise that a 2012 survey of more than 350 microfinance practitioners and analysts from 79 countries revealed that over-indebtedness was the number one concern.⁵

As bad as the situation can be for lenders, the consequences of over-indebtedness are typically devastating for individuals and families, who are often already poor, or nearly so. Faced with spiraling debt, exorbitant penalties and sometimes heavy-handed collection practices, over-stretched borrowers may feel they have little recourse except to refinance their debt with even more loans, or to liquidate their personal and business assets. The economic pressure puts additional strain on the extended family and can even pit neighbor against neighbor when group guarantors are forced to absorb the debt of a defaulting member. For mission-driven MFIs, the possibility of pushing clients deeper into poverty and unraveling their support systems raises very troubling prospects.

Surprisingly, given these consequences, there is not a lot of research that explores the underlying causes of over-indebtedness. Lenders are naturally aware of growing competition, and stories quickly circulate about distressed customers or borrowers who feel they were deliberately misled by credit providers eager to make a loan. But there are two parties to every loan agreement, and every over-stretched borrower has a unique set of circumstances and decisions that led to her current state. We feel that a systematic investigation into the different ways that credit problems manifest in the lives of debtors and

⁴ <http://www.eluniversal.com.mx/nacion-mexico/2013/reforma-financiera-968696.html>

⁵ *Microfinance Banana Skins 2012, the CSFI survey of microfinance risk, Staying Relevant* (UK: Centre for the Study of Financial Innovation), p. 7. Accessed 10/21/13 at: http://www.csfi.org/files/Microfinance_Banana_Skins_2012.pdf.

their families could yield some useful insights, or at least allow us to consider possible solutions from the viewpoint of the people most affected – the borrowers themselves.

Signs of Trouble

FINCA currently serves 136,000 low-income people in Mexico with small individual loans, village bank loans and insurance, with a loan portfolio worth \$47 million. Since 2012, FINCA's managers have noticed a troubling trend: increasing over-indebtedness among potential clients. While credit officers are still able to find new loan applicants, it is becoming increasingly difficult to find new customers who don't already have several outstanding lines of credit, or who aren't behind in their payments on their existing debt, especially in certain regions.

At the same time, the Microfinance CEO Working Group⁶ – a collaborative effort of microfinance leaders working to create positive development for the industry – has been tracking markets worldwide for risk factors. Mexico deserves special attention because it has exhibited an enormous increase in consumer lending, not just among microfinance institutions and commercial banks, but also payday lenders, pawn shops, and retailers. As early as 2007, *Business Week* noted that in Mexico, “even Walmart has a banking license.”⁷ New players aren't the only ones fueling this growth. Credit cards are proliferating, and banks have increased lending limits for many customers. According to *Euromonitor*, a financial strategy researcher, payday loans alone increased by 100 percent in 2012.⁸ Further, since enabling legal changes in 2006, Mexico has gained more than 3,000 unregulated credit providers, registered as a Multi-purpose Financial Associations (*Sociedad Financiera de Objeto Múltiple*, or SOFOM in Spanish), whose lending activities are not subject to banking oversight.

In addition to the present study, the executives of the Working Group commissioned the risk managers from their respective organizations to produce a publication, *Over-Indebtedness: A Risk Management Approach*, to identify the leading indicators of over-indebtedness and propose mitigating strategies. With a particular focus on the identification and mitigation of risks, the risk managers' publication is intended to complement our efforts, so that together the two papers provide a more comprehensive picture of over-indebtedness and

⁶ The Microfinance CEO Working Group includes the CEOs of eight microfinance organizations: *Acción*, FINCA International, Freedom from Hunger, Grameen Foundation USA, Opportunity International, *Pro Mujer*, VisionFund International, and Women's World Banking.

⁷ Keith Epstein and Geri Smith, “The Ugly Side of Microlending,” *Business Week*, December 12, 2007. Accessed online 10/12/13 at: <http://www.businessweek.com/stories/2007-12-12/the-ugly-side-of-microlending>.

⁸Euromonitor International, “Consumer Lending in Mexico,” January 2013. Accessed online 10/12/13 at: <http://www.euromonitor.com/consumer-lending-in-mexico/report>.

possible solutions. The risk managers highlight a number of factors that we believe to be present in Mexico, including a fast growing GDP per capita, which went from \$10,000 in 2005 to over \$15,000 in 2012, accompanied by rapid growth in the MFI sector itself and the entry of consumer lenders in the microfinance market.⁹

Global Antecedents

As noted in *Overindebtedness: A Risk-Management Approach*, similar circumstances in other countries have preceded debt crises. In particular, the authors cite examples in Bolivia and India. Further, a 2010 CGAP analysis of credit crises in Nicaragua, Morocco, Bosnia-Herzegovina, and Pakistan found three common denominators—circumstances that are also beginning to be evident in Mexico:

- Concentrated market competition and multiple borrowing
- Overstretched MFI systems and controls
- Erosion of MFI lending discipline¹⁰

In a 2011 survey of 500 microfinance institutions from 86 countries, credit risk was cited as the number one concern among microfinance practitioners, investors and analysts. Over-indebtedness was the main driver: “Above all, credit risk is seen to reflect the fast-growing problem of over-indebtedness among millions of microfinance customers: poor people who have accumulated larger debts than they will ever be able to repay.”¹¹ By 2012, over-indebtedness had assumed the top spot as the issue most on stakeholders’ minds: “The key finding of the survey is that over-indebtedness among microfinance borrowers is now seen to be the most pressing risk facing the industry.”¹²

According to a 2012 MIX study, “Those microfinance markets with the most lenders and most competition for MFI clients have seen the highest increases in risk, and likely, client over-indebtedness.”¹³

⁹ Microfinance CEO Working Group, *Over-Indebtedness: A Risk Management Approach*.

¹⁰ Greg Chen, Stephen Rasmussen, and Xavier Reille, “Growth and Vulnerabilities in Microfinance,” (CGAP: February 2010). Accessed 10/28/13 at: <http://www.cgap.org/publications/growth-and-vulnerabilities-microfinance>.

¹¹ *Microfinance Banana Skins 2011, the CSFI survey of microfinance risk, Losing its fairy dust* (UK: Centre for the Study of Financial Innovation). Accessed 10/28/13 at: <http://www.citi.com/citi/microfinance/data/news110125b.pdf>

¹² *Microfinance Banana Skins 2012, the CSFI survey of microfinance risk, Staying Relevant* (UK: Centre for the Study of Financial Innovation), p. 7. Accessed 10/21/13 at: <http://www.citi.com/citi/microfinance/data/news120628.pdf>,

¹³ Luis A. Viada and Scott Gaul, “The Tipping Point: over-indebtedness and investment in Microfinance,” *MIX MicroBanking Bulletin*, February 2012. Accessed 10/28/13 at: <http://www.themix.org/publications/microbanking-bulletin/2012/02/over-indebtedness-and-investment-microfinance>.

Mexico's apparent surge in over-indebtedness occurred some two years after a crippling microfinance crisis in Andhra Pradesh, India in 2010. In that region, a \$350 million IPO by SKS, the largest MFI, capped a period of rapid expansion and exemplified the belief that unlimited growth was on the horizon. On the ground, however, the proliferation of questionable behavior – described in a recent *Economist* article as a combination of reckless lending and strong-arm collection tactics – resulted in drastic consequences for borrowers.¹⁴ Encouraged by authorities, borrowers stopped making payments on their loans. Across India, the microfinance industry's portfolio at-risk grew to an all-time high of 25 percent.¹⁵ Although there are recent signs of recovery, the crisis caused India's microfinance market to contract significantly, and many institutions were unable to absorb the losses.

Investigating the Problem in Mexico

We devised a three-part research program including: (1) analysis of credit bureau data to gauge the extent of the problem; (2) a survey of branch managers to gather their observations of the local markets, and (3) in-depth interviews with borrowers – both over-indebted and otherwise – to understand more about the factors influencing their situations.

In the credit bureau analysis, we looked at a large pool of FINCA loan applicants and examined the repayment status of their pre-existing credit accounts. This allowed us to make some general observations about the level of debt and the prevalence of arrears. We combined these data with a survey of over 100 FINCA branch managers from around the country in order to capture the well-informed perceptions of those who are most knowledgeable of their local markets. Together, these two sources of information gave us an understanding of the prevailing conditions and provided a rich context for the third part of our research program, in-depth client interviews. The interviews were structured according to the principles of rigorous qualitative research, allowing us to analyze, combine and compare the various interview data in order to form a composite picture of how clients understand their current situation and the factors that got them into trouble.

Credit Bureau Data and Branch Manager Survey

Prior to disbursing loans to new clients, FINCA regularly reviews records from *Circulo de Crédito*, one of two credit bureaus operating in Mexico, and the only one that offers

¹⁴ The crisis is well-documented, but this article summarizes events and provides an update on recent developments (<http://www.economist.com/news/finance-and-economics/21569447-industry-starting-revive-road-redemption>)

¹⁵ Rahul Shyamsukha, "India: Post Microfinance Crisis Results," miX Microfinance Information eXchange, November 2011. Accessed 10/12/13 at: <http://www.themix.org/publications/mix-microfinance-world/2011/11/india-microfinance-post-crisis-results>.

information on low-income consumers and credit providers.¹⁶ We analyzed the records for 26,869 FINCA loan applicants across the country from November 15, 2012 to February 15, 2013 in order to establish the volume of debt and arrears among potential borrowers.

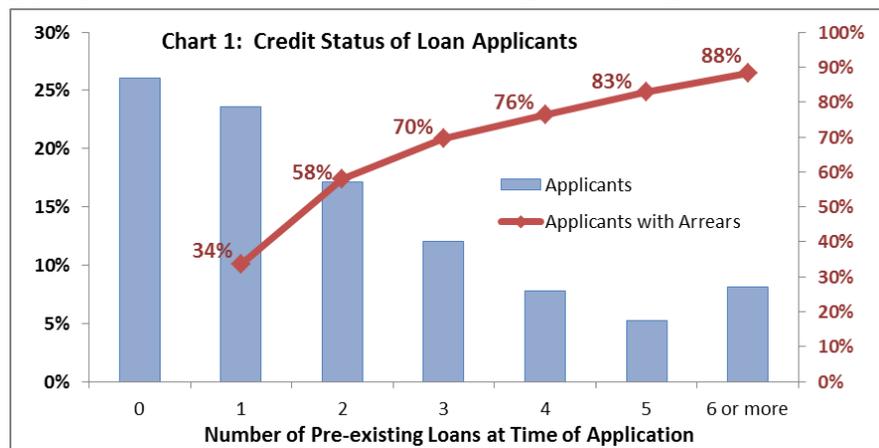
Before we could reach any conclusions, we noticed some problems with the credit bureau information. Many institutions don't report data, or they only report credits with more than 60 or 90 days' delinquency. As a result, we could not determine with certainty the percentage of delinquent customers in the market, nor could we determine how many loans a client had with other financial institutions. We also heard claims from bank managers (and some clients), that certain creditors deliberately show them as "past due" on their last payment, in order to prevent them from going to other providers.

To test the data, we conducted a series of phone and in-person interviews with a subset of customers in the initial sample. These interviews did not allow us to determine the degree of error, but it seems clear that the data are not complete or fully up-to-date.

Incidence of Debt and Arrears

Mindful of the data limitations, our first observation, as shown in Chart 1, is that only 26 percent of individuals applying for credit from FINCA had no pre-existing loans at the time of their application.

Forty-four percent were already in arrears on other accounts. The incidence of arrears increases with the number of existing credits. Thirty-four percent of applicants with one loan were in arrears. At three prior



loans, the percentage of individuals in arrears more than doubled to 70 percent. Among the eight percent of applicants with six loans or more, 88 percent were in arrears.

¹⁶ The other credit bureau, *Buró de Crédito*, was founded in 1995. It receives information from, and is 70% owned by, commercial banks.

The preceding figures tell us how many people have missed a payment, in relation to the number of loans they had at the time of application. In order to gauge the severity of the

Table 1: Incidence of Arrears

Type of Credit	Avg Bal (\$) Outstanding	% of Accounts in Arrears	Overdue Bal (% of total)
Department Store	185	59%	46%
Personal Loans	894	58%	51%
Microfinance	363	53%	40%
Savings Association	954	40%	22%

problem, we looked at the share of total debt that is in arrears, or the overdue balance as a percent of the total due. As shown on Table 1, we were able to disaggregate this analysis by the type of account and thereby compare the debt

situation as it relates to the different sources of credit. The table shows four of the account types with the highest incidence of arrears. While department store credits have the highest percentage of accounts in arrears (59%), the overdue balance is highest among personal loans (51%). Fully 53 percent of the MFI accounts among our sample were in arrears, with the overdue amounts comprising 40 percent of the total balance.

Certain cities exhibited much higher rates of arrears than others. In our sample, the highest rates of late payments were in Mérida, with 76 percent of loans in arrears, Veracruz, with 53 percent and Córdoba, with 35 percent. For comparison, three other cities, Puerto Escondido, Oaxaca, and Cuatro Caminos, had arrears ranging from 12 to 13 percent. As shown in Table 2, of the seven cities with the highest incidence of arrears, shown in

Table 2: Arrears by City

City	% Applicants in Arrears	Overdue Bal (% of Total)
Tuxtla Gutierrez	69%	35%
Veracruz	66%	55%
Cordoba	66%	36%
San Andres Tuxtla	65%	32%
Leon	61%	55%
Coatzacoalcos	61%	31%
Merida	57%	80%

the table, six of them – all except Leon – are in the southeast of the country. It was not within the scope of our research to explain the differences in arrears rates between the different localities, but it obviously would make for an interesting line of inquiry.

These credit bureau data paint the picture of a challenging marketplace. The pool of potential customers with few outstanding loans and no arrears is quite small, and the fact that 21 percent of applicants had four or more loans is in itself alarming, particularly considering that the applicants are low-income individuals. While department stores and personal loans show widespread problems, it is also worrying that over half of the existing microfinance accounts from among our applicants are overdue. In sum, the evidence shows an alarmingly high incidence and severity of over-indebtedness and arrears throughout the country, and microfinance organizations are right in the thick of it.

Other sources confirm the increase in available credit in Mexico, as well as increased competition among multiple types of credit providers, aggressive lending practices, and poor portfolio performance among certain lenders. According to a 2012 MIX report, “intense growth in competition has been observed, leading to market saturation, especially in the south of the country.”¹⁷ In 2012, financial strategy researcher Euromonitor noted that lending amounts were “growing at a greater pace than the number of borrowers, which signals a growing indebtedness amongst consumers.”¹⁸

Branch Manager Survey

In March of 2013, we conducted an online survey of FINCA’s branch, agency, and regional credit managers, with all of FINCA’s 103 managers participating. These managers deal with debt issues every day, both on an individual and institutional basis. They work with credit officers to determine whether or not to approve loan applicants; they enforce FINCA standards and policies; they market FINCA products; they strategize on ways to cope with competition from other lenders; and they monitor FINCA’s overall performance. In sum, they can provide a wealth of detailed local information on the market. We compared managers’ responses with credit bureau data and used it to inform our subsequent interviews with borrowers. Managers were also asked to give their opinions of key players and changes in the microfinance market over the past six months.

The FINCA managers’ survey points to a difficult market for MFIs. In their view, the market is generally characterized by increased competition for clients, relaxed credit standards, and the proliferation of deceptive practices among certain providers.

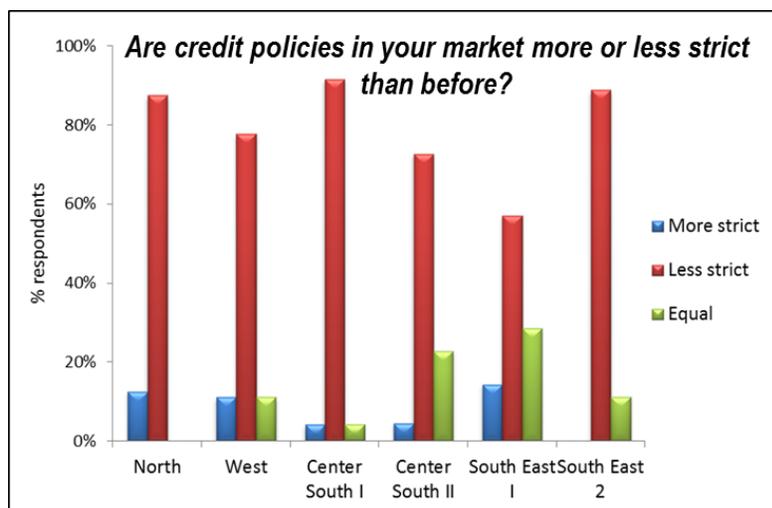
Increased Competition. Seventy-three percent of managers stated that, within the last six months (September 2012 to March 2013), they had noticed a significant increase in competition for clients. Additionally, 77 percent said that it had become more difficult to find qualified clients. And 60 to 90 percent of managers in all regions where FINCA works said that over the past six months, it had become easier for potential clients to obtain credit with other MFIs. Said one respondent, “Currently the market is being attacked by the huge number of microfinance institutions in the field, and some of them offer credits without [reporting them to] the credit bureau; others give loans without consulting the client’s records. All these situations cause a debt overload in the market.”

Relaxed Credit Standards. Overwhelmingly, credit managers also indicated that credit policies among all types of providers—excluding banks—had become less strict over the past six months. More than 75 percent said that pawn shops and other types of lenders had relaxed

¹⁷ “Latin America and the Caribbean Microfinance Trends, 2006-2011,” Ibid., p. 16.

¹⁸ Euromonitor International, “Consumer Lending in Mexico,” January 2013. Accessed online 10/12/13 at: <http://www.euromonitor.com/consumer-lending-in-mexico/report>.

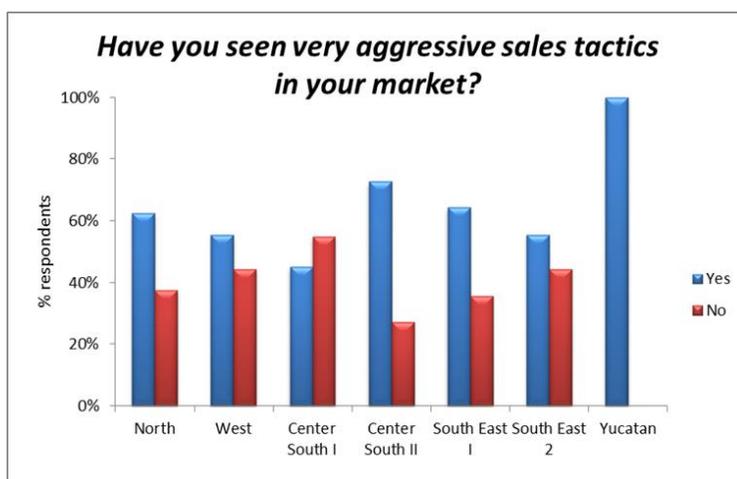
their rules, and well over 80 percent said that both MFIs and savings groups had become less strict.



Moreover, these practices appear not to have been geographically confined. Managers in all parts of Mexico agreed with the view that local MFIs had become less strict in their credit policies. In the words of one manager, “Oversupply in the market makes it easy to access credit, and customers with little or no financial literacy receive credit without assessing their ability to pay.”

Overly aggressive and deceptive lending practices. The majority of managers felt that certain credit organizations were using misinformation to target the most vulnerable clients. According to one FINCA manager, “To obtain more clients, no matter their socio-economic situation, Company X [name deleted] gives false information and takes advantage of the ignorance of the women through deceitful means.” Another manager stated: “Some providers over-extend the clients’ borrowing capacity; they don’t analyze the client’s finances and so they give the client more credit than he or she can repay, turning people who once paid on time into bad clients.”

The managers also noticed overly aggressive lending tactics. “While promoting their institution, credit officers indicate to people that if they form the group at that moment, the officers will give them the cash immediately,” said one survey respondent. “In that way, the officers make clients sign on the spot. However, the clients have obligations they do not know about.” Others reported tactics to discourage competition, for example by claiming that a competing organization is about to close down.



Clients Do Not Fully Understand Loan Terms. The branch managers agreed that clients often do not understand the terms of their loans. This is partly due to lack of education, and partly due to the language used in contracts or “the fine print.” Nor do they always understand how much interest accrues to different loans, so borrowers often will go with whichever lender will give them the largest loan the fastest. As a result, they do not understand how their problems might be compounding as they move from one lender to the next, incurring fees and stiffer consequences for default.

Pathways to Debt: Client Interviews

Most importantly, we wanted to hear from borrowers themselves, in order to map the problem of over-indebtedness from their point of view. Our research program was designed to elicit their histories and views towards their situation. Data were collected by local staff who received both classroom and field training on qualitative research techniques. The interviews lasted from 30 to 90 minutes and covered a wide range of topics: business history and operations, household income, family situation, experiences with creditors, use of credit and financial decision-making. All interviews were recorded and transcribed for analysis. The names that are printed here have been changed to protect the privacy of our participants.

Our goal was to document the circumstances that induced them to take on excessive credit, as well as the incentives and decisions that shaped their current situation. We were interested to understand the different ways in which their specific problems developed and to learn how the debt burden was affecting their lives. With this information, we hoped to discern solutions that start with the perceptions and motivations of the borrowers themselves.

Our research methodology has its limitations and advantages. Qualitative interviews do not allow us to weigh the factors that determine a borrower’s state of over-indebtedness, though we do note recurrent patterns and issues. Nor do they enable us to make strict comparisons among the various drivers of debt, because the data do not come from a statistical sample.¹⁹ In this regard, our data are exploratory rather than conclusive. Yet these interviews provide

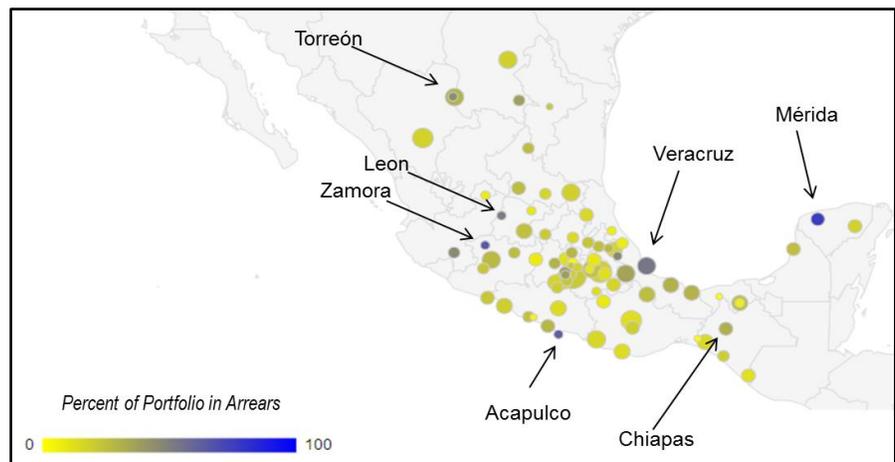
¹⁹ To learn, for example, whether clients were increasingly unable to repay their loans, we would have had to collect time series data for the numbers of unpaid loans. We would also need to know about the characteristics of borrowers, both those able and unable to repay the loans, to see if the increased indebtedness was due to MFIs’ giving loans to more risky clients, or whether similar clients were less likely today to repay their loans than previously.

insight into how circumstances in individuals' lives drive their interactions with credit providers, and how the lenders' practices helped or hurt them.

We purposefully weighted our selection of subjects towards those who were – or had recently been – over-indebted, rather than constructing a sample group that would be representative of microfinance clients overall. While it did limit some of our conclusions, this selection method afforded us the deepest possible view into the specific nature of over-indebtedness amongst our subjects. FINCA's local managers identified 32 individuals with debt problems, as well as 20 borrowers who did not have significant debt for purposes of comparison. Most of our interviewees were FINCA clients, while others had only recently applied for a loan, and yet others had been rejected by FINCA. A third group consisted of friends of FINCA clients who borrowed elsewhere.

Although it was not a criterion for selection, we found that most of the interviewees had been required at some point to make a solidarity payment for another member of their credit group. Some had encountered worse problems, such as fraud within their groups. Those who had to pay for others were unhappy about it and, in fact, we found that it was a common reason for switching from one lender to the next.

We chose a location – Veracruz, on the central Gulf Coast – that showed marked over-indebtedness according to our review of credit bureau data and where there is a wide variety of competing creditors, including banks, MFIs, retailers, pawn shops and moneylenders.



Although over-indebtedness appears to be especially severe in Veracruz, our data do not indicate why the problem is worse there than, say, Oaxaca, which has a higher rate of poverty. Nor does it tell us whether over-indebtedness is increasing or diminishing throughout Mexico. Despite these limitations, the qualitative interviews gave us insight into the circumstances and behaviors that drive spiraling debt, especially when viewed alongside the credit bureau data and branch manager surveys.

Benefits from Micro-Credit

A number of clients described ways in which their lives had improved through access to credit.

Maria Clara, for example, is a single parent who operates a catering business. She has had two loans for the past three years, one from *Compartamos* and the other from FINCA. Her outstanding credits, which totaled 60,000 pesos (\$4,640) at the time of her interview, were used to purchase cooking materials, appliances, and to fix up her kitchen. She had recently moved from selling in the street to building a patio at the back of her house that serves as a restaurant. “I have really gotten good use out of the loans I’ve received,” she told us. Nor has she had a problem with repayment. “Everything is invested [in the business],” she said “because it is intended for us to grow...otherwise, how would I make the payments?”

Maria Clara’s business has its ups and downs, but she added that, “with the loans, I always have some financial cushion.”

Another interviewee, Dolores, is married with three children. She has four loans for her various businesses, but only the FINCA loan is large. One loan, she said, “was only to complete the group” that her friends invited her to join. Her main business, selling jewelry, is seasonal and sometimes requires extra inventory. Like most respondents, Dolores has more than one enterprise. She has no credit cards, but she does have a savings account and feels that she is doing well.

Being indebted to multiple lenders is not necessarily a bad thing in all cases. One respondent, Carlotta, reported that she has five loans: one each with FINCA, *Compartamos*, *Felicidad*, *La Manderina*, and *Solidad*, and she effectively combines them in order to match her cash flows. She was not critical of lenders, because, as she said, “all of them have assisted me in a good way.”²⁰

Notwithstanding the success stories, our subjects consistently described some common pathways into unmanageable levels of debt: borrowing for emergencies, borrowing for household consumption, and borrowing for others. These pathways are not mutually-exclusive, but each one presents a particular set of circumstances that led our respondents into excessive borrowing.

²⁰ We have chosen to preserve the names of any organizations that our subjects specifically mention. We do so with the sole purpose of retaining the authenticity of their accounts. However, we did not verify any of their assertions, positive or negative, concerning the organizations in question and therefore disclaim any association of the subject’s views with our own.

Borrowing for Emergencies

As credit is increasingly available to a growing share of the population, particularly those who are poor (or nearly so), it becomes more important for dealing with family emergencies. Such emergencies – especially a sick or dying family member – can plunge a family into crisis. Borrowed money is a lifeline, but it comes at a high cost. Since the loan is consumed and not invested, it brings temporary relief but the family is left with additional obligations that can make their future struggles all the harder.

Idoya, for example, described using her loan proceeds to travel to her father's funeral and pay his funeral expenses:

Idoya: I used the loan when my father died. I received it on December 16, a Friday. That day I was told he had died. I wasn't going to use it for that purpose.

Interviewer: Did you spend the entire loan?

Idoya: Yes, because [my father] lived in Tierra Blanca, he had another partner and children there, but they depended on us for the money. There were many expenses, because we needed food for the people [who came to the funeral]... We hadn't planned to use [the money] for the funeral, but unfortunately, it happened.

Having made no investment in her business, Idoya was struggling to repay her loan.

Idoya's story illustrates another common theme: for those who are in economically precarious circumstances, the extended family is a mixed blessing. Just as it can provide some support in times of need, it can also be the source of obligations that lead to a spiraling debt situation.

We interviewed both Mariana and her mother, Valeria, and each described having to cope with a wayward family member. Their family ran a business installing telephones under contract with TELMEX. They needed a vehicle to allow them to "climb the poles and do the wiring" and to transport tools to installation sites. Mariana told us:

Two years ago my mother received a loan and bought a van. A nephew of my father disappeared with the van and all the tools. That was a big loss. The money invested in the van was 20,000 pesos (\$1,546) and in the tools, it was between 5,000 and 6,000 pesos. It was hard to regain what we had lost. We had to use a different loan to buy another truck, but this vehicle was old and in bad condition.

Both mother and daughter were heavily over-indebted. The mother, Valeria, had three business loans in addition to her mortgage. She said she was living "from loan to loan." Mariana, who helped her mother and ran an Internet business with her boyfriend, had an

additional four loans. When times were difficult, Valeria pawned her jewelry and then used a business loan to get it back.

Unexpected medical problems also occasion borrowing, sometimes with little regard for cost. One client used a loan to pay 15,000 pesos (\$1,160) to cover an appendectomy for her son. At the time of the interview, she had four loans, one each with FINCA, *Compartamos*, *Micronegocio Azteca* and *Finsol Microcrédito*. She also shared one of these loans with her brother, even though it was in her name.

Borrowing to Consume

Using credit to finance consumption – whether buying household appliances, a car, or to modernize one’s home – is not an uncommon behavior, though it was the least frequent explanation among our interviewees. Some clients admitted to spending their loan funds on non-essential items, although very few of the expenditures could be called an extravagance. Katia, for example, used loans to make school payments and purchase a uniform for her daughter. At the time of the interview, she had one loan outstanding and another waiting for approval. She knew that the money was intended for investing in her business only, but like several of our other subjects, she quoted a local saying “*en manos de los pobres, pobre dinero*,” implying that money easily slips through the hands of the poor.

Luisa used the major part of her latest loan for her business, but one-third of the money went to pay off a bank loan, to buy food, and to pay off credit card debt. She had used the bank loan to help pay for a medical emergency and the credit card to purchase clothing from Sears. These behaviors are familiar to anyone who uses debt in their day-to-day life.

A few clients did admit to borrowing money that they did not need, however, calling themselves “addicts” of the system. Cruzita explained that she did not want to borrow any more money, because when she did, she became a compulsive spender. Yet each time her loan came up for renewal, she borrowed again, because she was addicted to the thrill of having money to spend. She had been able to pay on time, but was dragging down her family’s prospects in the process.

Borrowing for Others

Some respondents, particularly in group lending programs, felt pressured to recruit friends in order to achieve a certain group size, whether or not those friends actually needed additional credit. A number of other subjects explained that some of those lines of credit were for other family members, not themselves. When certain individuals are denied credit, they turn to family members to borrow for them. Several clients told us that, since their MFI prefers to lend to women, they borrowed for the men in their lives. With her name on the

loan record, the borrower suffers when her husband or other family members are unable or unwilling to repay.

Guadalupe told us that two of her three loans were for her brothers and her sister, and only one was for her own business. She had major problems with credit cards in the past and had lost many things as a result, because “we used our material possessions to pay our debts. I lost my car.” She did not want to be in debt anymore, but she was struggling to repay the debts in her name. She had taken out a loan from *Compartamos* for her brother, and he was having difficulty repaying her. She rationalized her actions by saying “he only has his shop, and it is the only way I can help him, so I have to do him the favor.” But she had a pessimistic view of being able to get out from under so much debt: “It’s a lie that you can recover. On the contrary, you keep getting worse and cannot pay off the things you have.”

Sink or Swim

The majority of interviewees were on a path to recover their credit standing. But some of the most heavily indebted clients described a downward spiral, in which they used one loan in an effort to restructure their credit, only to find themselves deeper in debt and burdened with additional fees.

Graciela had applied for a small FINCA loan to start a business making charm bracelets. She had previously shared two store loans with her sister. She had paid off one with a loan from an MFI, but had not been able to pay off a department store credit card bill, and as a result, was negatively rated on the credit bureau. Her financial situation worsened when her marriage ended:

He [my husband] was the one who paid [off the credit card], but it was in my name. Later, we separated and I wasn't working, so I couldn't pay it. When I started working, I began paying the credit card, but by then, they had raised the interest rate, and I was consumed by the interest rates, and so I ended up on the credit bureau's list.

Valeria and Mariana, the mother and daughter whose telephone installation business had failed due to a dishonest family member, had also struggled to pay off past debt and regularly used one loan to pay another.

As soon as I get the [loan] money, the bills arrive. The first thing I do is list my debts. If I have an excess, I spend it, as I told you, to buy an apple or a soft drink; if I don't have money left over, that's OK.

Valeria viewed loans as a way out of debt, and she was hoping to get a big loan so she could pay off all her debts and build her business. Mariana's situation was even worse. Her credit cards had been stopped because she withdrew money for others who did not pay her back.

She had stopped making payments on her prior FINCA loan because, as she said, other group members hadn't wanted to pay or had delayed their payments. She was still paying off her credit card debt to try and improve her credit rating and to qualify again for a loan from FINCA.

Fuel on the Fire

Though it was not a frequent response, some respondents blamed deceptive, high-pressure sales techniques – or pressure from neighbors and credit group members – inducing them to borrow beyond their needs or means. They recounted experiences in which lenders encouraged them to borrow money while hiding or misrepresenting the high interest rates, penalties, or even the loan repayments that they would incur.

Aggressive Marketing. Our interviews revealed that credit cards were the most common vehicle by which clients got into financial difficulties, most likely because of their ubiquity, ease of access, and the perception that it is easier to skip payments with credit cards than it is with other types of loans.

Elisa obtained all three of her credit cards—which caused her to be reported to the credit bureau—from people offering them in the street near her house.

Sears was offering credit cards door-to-door. I was home when they came to the door, and they showed me how it works. I was authorized for five thousand pesos (\$387).

Famsa was also offering credit cards in the street.

I had had a credit card with Coppel since the company opened. They were promoting cards in the street, and in the beginning, I used it a lot and it was very useful. But after a while the interest got high.

Some MFIs also recruit borrowers with little regard for their current financial situation. This is how one client, recounts obtaining an MFI loan, despite being deeply in debt:

Because I was in charge of the group, the credit officer said I could have a loan of 12,000 pesos (\$928). I didn't want to be rejected later, so I mentioned to him that I had been reported to the credit bureau. Nevertheless, I received a loan of 20,000 pesos (\$1,547). That was much more than the established limit—6,000 pesos—but he said that I was trustworthy, and he was sure that I wouldn't fail to make my payments.

Given her situation, this story illustrates a serious lack of oversight and prudence on the part of the lender.

Hidden Fees. Some borrowers told us that they preferred to use microfinance loans to buy large items, rather than credit cards or store loans, because the interest is lower. We heard time and again that credit companies charge double the amount of the original purchase by the time the purchaser has paid up, and more if payments are late.

This is especially true when penalty charges are not made clear to borrowers. Milagros' story was typical of many. After her husband, a taxi driver, broke his leg, Milagros found that, unbeknownst to her, he had taken out a 5,000 peso (\$386) loan from a consumer lender:

I was very angry because the institution threatened to harm our family if he did not pay; they would come and take everything they could. I went to talk to the manager, and he told me we had to pay nearly 20,000 pesos (\$1,547), because for each day the payment was delayed, they charged 525 pesos (\$40). I told them it was not fair that they took advantage of our ignorance or lack of money. I told them I could not pay 20,000 pesos; I was going to pay them what my document said. I left crying, not knowing what to do.

Milagros explained that banks demand that clients sign “lots of documents with small letters and articles that we don’t understand.” This complaint was echoed by our survey of branch managers, who state that borrowers often do not fully understand the terms of their loans.

The issue of unclear terms and hidden charges applies to savings as well as credit. When people open accounts, banks are supposed to offer the possibility of an account with no fees, but this doesn’t always happen. For example, Adriana had opened a savings account using a 1,000 peso (\$77) deposit. Later, she went to withdraw the money, but found she “didn’t have any money because they had charged it.” She was very confused. “I said that I had deposited my money, and they told me that I had to pay something every month and I did not understand.” She added, “I never deposited or made withdrawals.” A number of clients told us similar stories.

Solidarity Group Issues. Many clients ran into financial difficulties when other members of their village bank either could not or did not pay their share of the loan. Because most members have few resources, covering another person’s loan puts a strain on everyone. Carmen described the problem:

... when one person does not pay, the others are late in paying, too. It is like we drag one another down; I don’t know why, but it is harder to collect the payment. Our group started having problems because a woman who was in too many groups stopped paying. We had to put in money for her, and we paid almost 100,000 pesos (\$7,734). There were some who did not want to put in the money.

Why should I pay the loan of another person? They are solidarity groups, I agree, but . . . if one person receives “un solidario” [a group payment on behalf of one who doesn’t pay], then other people are going to think, “me too,” and be reluctant to pay for her. The credit managers say that if one does not pay, then everyone is reported to the credit bureau.

Sometimes, groups took it upon themselves to penalize the member who had fallen behind in payments. Guadalupe told us:

One time, one woman stopped paying, and we all went—and I mean everyone—and we rented a truck and we took everything from her. The [village bank] treasurer told her, “If you do not want to pay up, we will not give anything back to you.” She took everything the woman had and sold it to pay off her debt.

Several respondents explained that the more people in a borrowing group, the lower the interest rates are for everyone. So village bank members actively recruit additional members to take advantage of lower interest rates. Guadalupe explained, “There is always someone to offer you money.” She described having two loans with different MFIs, and being drawn into a third. First, she was with *Compartamos* and then, when her credit officer moved to a different MFI, she decided to join a FINCA group. Later, the same credit officer, now with FINSOL, offered her yet another loan, even though her loan from FINCA was in process, promising that the FINSOL loan would be faster.

The man that used to be in Compartamos would get us together to drag us to other groups. So, they keep pulling you to join other groups and that is what happened... he offered us a check from FINSOL before the FINCA one came through.

Poorly-Designed Services. Ironically, the issue for some borrowers is that the amounts that they are offered are *too small* and don’t fit with their cash flow. So they take out loans from multiple lenders, essentially constructing for themselves a line of credit out of a series of small, fixed-term loans. Luisa, for example, operates a business selling clothing and cosmetics. She had three outstanding loans—one each with *Compartamos*, FINCA, and Finsol. She felt that the limitations of the loan products themselves forced her to take out multiple loans:

The dates of my loans don’t match with my needs. At Easter, I receive a loan from Compartamos. Now comes Mother’s day, and I take out a loan from FINCA. These are the times when people are buying, which is why I have to take out multiple loans: to coincide with the selling seasons.

Luisa’s interview also revealed another common feature of our respondents’ stories: the various pathways to debt can converge on a single client. The seasonality of her business and occasional down periods had led her to incur credit card debt in order to pay for

clothing, food, and medical tests. She had had difficulty paying off the balance because the interest was high, so she had used part of the Finsol loan to pay off the credit card. She admitted to also using loans from *Independencia* to pay off her other loans from time to time. A combination of seasonal needs and emergencies had put her deeper into debt, and there were times when she could not make payments and the others in her group covered for her.

Squeezed on All Sides

Our interviewees recount numerous pressures: from family members; from their peers; from the vicissitudes of business; and from banks, retailers, and lenders. No one of these is principally to blame for driving them deeper into debt, but they do collide in the lives of our subjects and make for a very precarious situation. Just as there is almost always a need for money, for themselves or a family member, there is always some lender at hand eager to make credit available, sometimes on unclear terms and usually with little regard for the customer's financial circumstances. Obtaining credit is easy at first, regardless of one's financial condition. In fact, it is more often the borrower who has to resist the tactics of lenders, who show up at their doorstep, in their shops, and may even be represented by friends and neighbors who are recruiting members of a peer group.

When problems arise, however, debts start to accumulate and go unpaid. Borrowers eventually face the prospect of losing their access to credit because of their negative history. In response, *every* one of our subjects – regardless of what had led them to their current troubled state – was working hard to clear their accounts in order to regain a clean record. Even when they felt that they had been pressured or fooled by the lender, the clients were resigned to the situation and taking every step to repay their debts – penalties and all. Though there were isolated cases in which they attempted to negotiate down their payments, the borrowers rarely challenged their lenders and instead were focused on getting paid up.

Remedies

If lenders want to avert a meltdown, they should restrain their impulse for gaining quick market share and instead embrace more rigorous credit discipline as the foundation for sustainable growth. Such discipline begins with a serious effort to assess the financial condition of potential borrowers, and it includes not only transparency but an active effort to educate consumers about the terms of their loans, mutual obligations, and the consequences of late payments or default. These seem to us like the minimum standards to which every lender should adhere. While the call for voluntary action may seem idealistic, credit providers should take heed of the examples from other countries in which irresponsible lending precipitated a social crisis, with a ensuing public outcry and strong

response by government. *ProDesarrollo*, a national network of microfinance providers, can play an important role in educating lenders about the risks inherent in the current situation, and urge collective voluntary action around a customer-centered platform such as the Smart Campaign.

Our recommendations, therefore, start with the premise that it is in the interest of lenders to recommit themselves to the wellbeing of their clients. In this spirit, we propose remedies that will improve the quality of their services, mostly by making a better fit between the borrower's needs, as they were expressed by our participants, and the terms of credit. Judging by current conditions, however, such discipline may not come voluntarily or fast enough, so it will be up to the government and regulators to step in and protect the public's interest in a viable credit market.

It is beyond our scope or ability to propose a detailed program of government intervention. But there are clearly certain dimensions of the problem that lend themselves to a government response. These include the imposition of credit discipline by financial regulators, a broad-based campaign of public awareness – for example, encouraging consumers to seek out the services of Smart-certified lenders – and strengthening the mechanisms for consumer protection and redress. Mexico has very recently passed legislation that includes some strengthening of consumer protection by the Ministry of Finance, but it also contains many provisions that are likely to further accelerate the flow of credit to low-income sectors, such as an increase in the use of correspondent agents.²¹

Smart Lending. Many of the clients we interviewed might have avoided trouble if prospective lenders were as committed to quality – meaning, providing a tangible benefit to their customers -- as they are to making more loans. This focus on quality should encompass growth strategies, branch activities, loan officer incentives, and policies that drive the behavior of solidarity groups and village banks themselves. We are past the days when we could believe that the mere provision of cash, in itself, constitutes a benefit to clients. Instead, lenders need to concern themselves directly with how customers will use the funds they receive, the household circumstances and cash flow, and how the additional obligations will affect both their customers' short and long-term economic horizons.

Smart lending also requires much greater awareness and self-advocacy among borrowers, a majority of whom do not fully understand the terms of their loans. Improving borrowers' capacity goes beyond explaining loan terms, however. It should also cover topics such as how to manage their funds, as well as the risks of borrowing for others or diverting loan capital to unplanned uses.

²¹ <http://www.eluniversal.com.mx/nacion-mexico/2013/reforma-financiera-968696.html>

Deal with Households, not just Borrowers. Lenders need to consider the financial circumstances of the entire household, not just the nominal borrower, before making loans – including the likelihood that loan proceeds are being shared among an extended family. This step is tricky. It is probably not feasible or cost-effective to obtain an accurate accounting of the status of every family member. Nor is it desirable to discriminate against borrowers because of their family situation. However, given the frequency of family-related issues in driving borrowers into debt – including standing-in as borrowers for other family members – this is a matter that should not be avoided. It could perhaps be addressed through credit counseling with prospective borrowers, including other members of the household, home visits, or other forms of client education.

Loosen Up? While they are making serious efforts to clear their debts, most of our interviewees would have benefitted from some flexibility on the part of their lenders. It may seem paradoxical, but it is consistent with our emphasis on improving the quality of services to note that the rigidity of certain loan terms and can spur credit problems for clients whose cash flow is irregular. This flexibility could take different forms, including prepayments and grace periods. In retail, especially, where buying is seasonal and picks up in anticipation of holidays or the start of the school season, borrowers need to stock up on inventory. Loan cycles, especially ones that are fixed at the group level, may be too short or too long for individual members. For customers in high-turnover businesses, a flexible line of credit might be more suited to their actual cash-flow and reduce the tendency to take on loans with multiple lenders.²²

When a borrower is driven to seek out additional loans in order to manage his cash flow, he acquires new obligations beyond the view of the initial credit provider. This means that the conditions under which the original credit was approved are no longer in place, and the risk of excess leverage flows back to the first lender. By matching the credit terms more closely to the cash flow of the client, lenders can mitigate this risk and build healthier, more loyal relationships with their borrowers.

Strengthen the Safety Net. The lack of emergency resources was a primary cause for individuals becoming over-indebted or diverting loans away from their businesses. Rather than take out loans, customers would benefit from other products that are specifically designed for risk-management, such as insurance and savings. Such funds should bear real interest and ideally serve as a shelter from the demands of the extended family. Other changes could include emergency loans for qualified clients, grace periods, or the possibility to reschedule loans in exceptional circumstances.

²² The Client Protection Principles of the Smart Campaign detail a number of ways to fit products to the needs of clients, with a preference for simplicity and clarity of terms where possible. See www.smartcampaign.org.

Improvements in Group Lending. The solidarity guarantee is a foundational element of financial inclusion, making it possible for millions of people around the world – especially women – to gain access to credit, despite their lack of collateral. The mutual commitment of group members has proven to be one of the most effective means of securing small loans, and it is one reason that MFI loan portfolios can sometimes exhibit better repayment rates than those found in commercial banks. A successful credit group or village bank can also be a means of empowering its members, creating local leadership opportunities while encouraging a spirit of mutual help. It is not unusual for a village bank to serve as the first line of support when its members encounter trouble in their personal lives or in business.

Despite these advantages, credit groups are also vulnerable to abuse, both by lenders and members themselves. Dominant personalities can skew the group towards their own advantage, for example, by gaining approval for credit beyond their means, or in some cases outright theft. At the same time, a well-functioning group can be a ripe target for “poaching” by rival lenders. After a recent field visit, a board member of FINCA Mexico reported that she personally witnessed the credit officer from a competing lender hovering outside a village bank meeting, just waiting for the FINCA staff to leave before engaging with the entire group to sell them more loans.

In our own interviews, clients reported that they are pressured or incentivized to add more members, or that credit officers will offer rewards in return for forming a group on the spot. Such practices undermine the social bonds that make the solidarity guarantee possible in the first place. When one of their peers defaults, the responsible members end-up paying more than their share. The burden of these payments can undermine the morale of the entire group and even drive otherwise good members into delinquency.

MFI's should develop strategies to ease the burden of these solidarity payments or, better yet, to avoid them in the first place. For one thing, the practice of on-the-spot group formation should be eliminated in favor of a careful process of selection and training.²³ By rushing through group formation in order to make the fastest disbursement and possibly beat a competitor, the lender conveys a focus on easy money rather than serious, long-term engagement with clients. Clients perceive this emphasis and, in turn, treat the group as a vehicle for faster (or cheaper) loans, rather than a means of achieving solidarity and empowerment, thereby missing some of the most important benefits that a group can offer.

Public Awareness. There are two institutions in Mexico that could play a leading role in educating the public about the terms of responsible lending. One is *Condusef* (the National Commission for the Protection of Users of Financial Services, a specialized entity within the

²³ The Client Protection Principles include other useful recommendations for solidarity group lending. See www.smartcampaign.com.

Ministry of Finance), whose charter is to promote financial education and to resolve complaints by borrowers. Legislative reforms passed in January 2014 include some provisions to strengthen *Condusef's* role in monitoring SOFOMs and in protecting consumers, through a new Bureau for Financial Institutions. The other is *ProDesarrollo*, an industry-wide organization that is concerned with financial inclusion as a means to combat poverty. From the experiences of our participants, there is clearly significant scope to improve the scale and effectiveness of whatever programs may be underway to educate the public on responsible lending and the means to avoid trouble or gain redress.

Improvements to the Credit Bureau. Clients are clearly mindful of the credit bureau, and they are working hard to clear their records in order to have continued access to finance. At its best, a credit bureau can serve as an important resource for managing risk and ensuring that clients are not over-indebted. For it to serve that purpose, the data need to be complete and accurate. Nonetheless, we found indications that the credit bureau data are not always reliable, nor are they consistently used by lenders. Clients we spoke with often disputed their credit reports. One went so far as to claim that a lender deliberately failed to update the information so that she would be denied access to alternative sources of credit, an allegation that we also heard from staff. At the same time, there seems to be a high level of disregard for credit bureau data in the recruitment of borrowers.

Both borrowers and lenders would benefit from actions to address these deficiencies, starting with a collective commitment by lenders to provide updated and accurate information, and improved usage of the information in making credit decisions.

Adopt and Promote the Client Protection Principles. The Smart Campaign and its Client Protection Principles are intended as a guideline against which lenders can measure their focus on clients' needs. Every one of the recommendations from this report is consistent with these principles. The campaign offers a public platform to raise awareness about good practices among both lenders and borrowers. One key to the effectiveness of this platform is to ensure that the message of responsible finance is disseminated as widely as possible, so that borrowers can be on the alert for abuse and seek out lenders that can provide proof of their honest intentions. Another will be to ensure that the Client Protection Principles are embraced by the full spectrum of lenders – not just MFIs – including commercial finance companies, retail lenders, credit cards, pawnshops and the providers of store credit.

Conclusion

People in precarious economic circumstances are under enormous pressure to secure resources for their families, making them very susceptible to offers of easy credit. When they are unable to keep the repayment schedule (again, often due to family circumstances), they may weakly negotiate with their lender, but eventually find a way to pay, even if it means going deeper into debt. Ultimately, the lender regains its capital, usually with interest and penalties, but the borrower's economic prospects are worsened. Credit bureau data show that this problem is widespread, involving a high percentage loan applicants and creditors of various types. At the same time, staff and borrowers alike describe an environment in which creditors are almost frantic about growth, rushing to be the lender of immediate resort.

The prevalence of family issues and emergencies as a leading driver of credit-seeking behavior is surely nothing new. What *is* new is the vastly increased supply of creditors eager to make as many loans as possible. In this new environment, whatever strategies may have existed in the past for coping with household emergencies are being replaced with recourse to formal lenders. While informal credit sources have their obvious disadvantages, at least their terms are generally well-known to all participants. In contrast, a veil of ignorance seems to shroud many of the credit transactions described by our interviewees, both for borrowers and lenders. Borrowers, unaware or unthinking of the terms of their loans, are caught unprepared when the bill comes due, especially when it includes significant interest and fees. For their part, many lenders are unaware when loan proceeds are diverted to other family members or to deal with immediate needs rather than the stated purpose.

This type of situation seems more prevalent than, say, cases of outright abuse by lenders, and we saw little evidence of strong-arm collection tactics. However, in the rush to grow their portfolios, it also seems clear that many lenders are taking the shortest route to signing up new borrowers, without stopping to understand in any depth how they will be affected by the new obligations. At the same time, a number of product-related issues are driving clients from lender to lender, most of which boil down to a mismatch between the cash flow of the borrower, which can be irregular, and the repayment schedules of her credits. For its part, the solidarity guarantee, if not supported through careful group formation and member selection, can contribute to this problem when an otherwise good borrower is burdened with the repayments of a defaulter in her group.

Borrowers need to be empowered to be their own advocates, to ask questions and, in some cases, to balance their pressing family obligations against the costs and consequences of excessive debt. Given that so many of the financial instruments, such as store credit cards and payday loans, are relatively new (especially to poor customers), it is not surprising to find so many cases in which customers are getting into trouble. The problem is that, being

poor, many over-indebted borrowers do not have the means to recover quickly, so the toll on their families is higher, as is the likelihood that the problems will compound and grow worse.

Despite these risks, our interviewees confirmed that access to credit, on balance, is a positive factor in their lives. While some had negative experiences and despaired of ever getting ahead of their debt, other borrowers had positive experiences and praised their creditors for giving them the ability to pursue new and greater opportunities. All of those who had problems were working hard to resolve them so that they could re-open the flow of credit, hopeful of avoiding the pitfalls that had landed them in trouble.

Strong, voluntary action by the market-leaders could go a long way to helping to avert a crisis. If they continue to pursue growth (and profits) at their customers' expense, the experience of other countries shows that the eventual ramifications can be widespread, and the risks of a public outcry should not be taken lightly. Ultimately, as proposed by the Smart Campaign, a client-centered focus is the best foundation for a sustainable business, with rigorous credit discipline to underpin a strong loan portfolio.

Where self-discipline fails, however, it is up to the government to impose some minimum standards on lending practices. Considering the experiences of our interviewees, this oversight should focus on the process of credit evaluation and approval, and on full disclosure of loan terms. It is in these areas that borrowers are most exposed to the reckless behavior of lenders, who can confidently expect to get repaid regardless of the cost to their customers. This form of business, while not overtly abusive, nonetheless puts low-income borrowers at risk and diminishes their economic prospects. Lenders and government together should commit to ensure that Mexico's burgeoning financial system actually helps those who are most vulnerable, enhancing their efforts to get ahead, rather than becoming yet another obstacle in their struggle against poverty.