



aims to offer practical guidance to regulators<sup>3</sup> and policy makers who face such challenges.

As background for the policy and regulatory proposals discussed in this paper, Section I offers a brief overview of the dynamics of credit market cycles and describes how the factors driving the growth of a credit market may result in a credit bubble, followed by increasing defaults and eventual contraction. Understanding these dynamics is essential to grasping the limitations of traditional prudential supervision risk indicators and interventions in identifying and dealing with the risks of debt stress and over-indebtedness. We point out that when a credit market is growing rapidly, the increased supply of loans and high household liquidity may disguise actual levels of debt stress: defaults may be relatively low for a time, even when debt stress may be reaching unsustainable levels. Regulators are often unaware of the extent of debt stress until it is too late to take preventative measures.

Sections II and III propose a policy and regulatory approach for early-stage and high-growth credit markets. This approach aims to address emerging risks of debt stress without inhibiting the expansion of financial access. While there is a potential trade-off between these two policy goals, this paper argues that a sensible strategy can find the right balance. The main proposed measures, in general order of importance, include the following:

- Implementation of specific measures to detect potential debt stress at an early stage (when monitoring defaults may not be sufficient)
- Regulation of lending practices that may create incentives for reckless lending
- Rules requiring effective disclosure and complaints handling by lenders
- Measures to improve lending practices, potentially including guidelines on affordability assessments or the oversight of agents or brokers

- Expansion of credit information sharing and establishment of credit bureaus

These and other measures (see Table 1) will be discussed in further depth in this paper, highlighting a few key country examples. Further country examples of each measure are provided in Annex 1.

In implementing any of these measures, it is essential to recognize that countries differ substantially in their stage of credit market development, profile of credit providers and products, level of credit penetration, and regulator capacity. There may also be substantial differences in credit market development within the country. For example, a certain population segment (e.g., civil servants or salaried workers) or geographic area (e.g., urban centers) may be saturated while others still struggle with basic financial access. These factors affect the risk of debt stress as well as the nature of the policy response. An overly restrictive or prescriptive regulatory environment may limit the ability of credit providers to introduce innovative products or delivery channels. This in turn can undermine credit market development and strategies to increase access to finance. Thus, the priority in early-stage markets should be on monitoring early warning indicators; creating enabling infrastructure, such as credit bureaus; or removing legislative obstacles to lending.

It is similarly important to consider differences in countries' regulatory structures and institutional mandates, which may limit regulators' ability to cover all relevant segments of the credit market. Such limitations may make it challenging for any single regulator to effectively manage debt stress that results from activities in unregulated or under-regulated segments of the market. Coordination among regulatory agencies and efforts on the policy front to close such gaps are essential.

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<sup>3</sup> For simplicity, this paper uses the term "regulator" to describe the authorities that regulate and supervise financial institutions in a particular country.

**Table 1. Summary of Early-Stage Regulatory or Policy Interventions to Prevent and Address Debt Stress**

Monitor signs of potential debt stress	Regulators can monitor trends in statistical indicators for potential debt stress and assess market practices that may aggravate the risk of debt stress. Early-warning indicators include rapid growth in individual institutions' portfolios with a simultaneous rapid expansion in the number of lending institutions; concentration of lending to certain population segments (e.g., government servants/salaried workers); rapid growth in average loan size or loan term; increased loan rescheduling and refinancing; and increased arrears and default.
Regulate high-risk market practices	Regulators should address market practices that increase the risk of unsound or predatory lending. <sup>a</sup> For instance, payroll deduction facilities have led to debt stress in many countries, often among politically sensitive market segments such as government employees. Similarly, when collection methods are unregulated, the practices of predatory credit providers can become a political issue, even if only small numbers of people are affected. Unsolicited credit and automatic increases in credit limits are further examples of high-risk practices. Regulating such high-risk practices at an early stage can reduce the incentive for high-risk lending without unduly hindering responsible lenders.
Support credit bureaus	Effective and inclusive credit bureaus add value in nearly every environment. In low-inclusion environments, improved credit information lowers the cost of credit assessment and loan origination and creates an impetus for growth. In a high-risk environment, it can help credit providers identify debt-stressed individuals, reducing credit risk in the market. Credit bureaus should include both positive (full-file) and negative data, and include both bank and nonbank lenders.
Support lender standards and ombudsman schemes by industry	Regulators can require that industry codes contain guidelines for responsible lending, including affordability assessment requirements. Regulators can also require that financial institutions establish internal complaints and recourse mechanisms and report complaints data to the regulator. Further, an industry-funded ombudsman scheme could provide a mechanism to handle consumer complaints and offer accessible redress, without requiring regulatory resources.
Foster consumer awareness	Messages relating to household debt management and over-indebtedness risk should form part of any national consumer awareness and financial literacy campaign.

a. There is no single definition of "predatory lending," a term that can encompass a range of misleading, manipulative, or abusive lending practices. John Hawke, Jr., defined this term and presented examples of a range of such practices in his statement to the U.S. House Committee on Banking and Financial Services in 2000. Morgan (2007) described predatory lending more generally as "a welfare-reducing provision of credit." See Hawke (2000) and Morgan (2007).

In the meantime, regulators should, at a minimum, broaden their monitoring efforts to capture potential spill-over effects from other segments of the market that may increase overall debt stress.

## I. Dynamics of Credit Cycles and Debt Stress in Expanding Markets

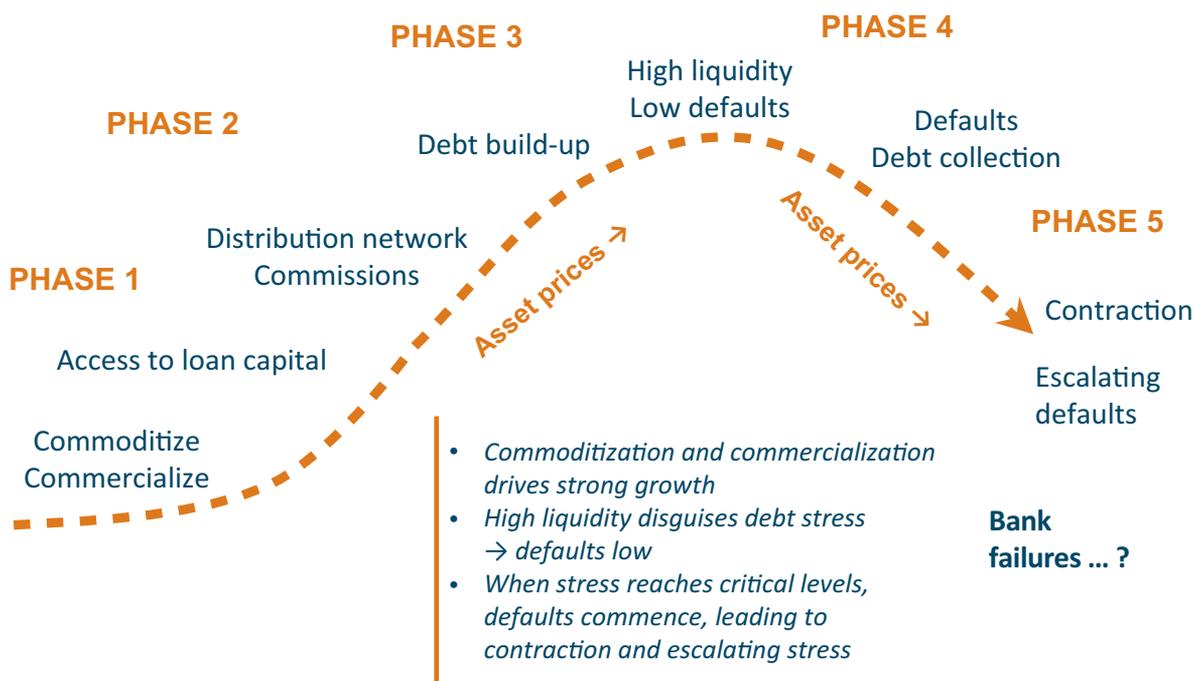
### A systemic view of credit market cycles

The inherent dynamics of credit market development can lead to cycles of credit growth and consumer debt build-up followed by large-scale default and

contraction. These cycles have significant policy and regulatory implications:

- Understanding this may help those involved move beyond the competing ideologies that blame over-indebtedness either entirely on indulgent and irresponsible consumers or on predatory and reckless credit providers.
- Understanding these cycles helps regulators detect the level of debt stress relative to the level of credit market development.
- Perhaps most importantly, understanding these cycles is essential to crafting appropriate policy and regulatory responses.

Figure 1. Credit Market Cycle: From Expansion to Meltdown



### Phases of expansion and contraction in credit markets

Cycles of growth and contraction are quite predictable and have been observed in many different market sectors.<sup>4</sup> Recent cycles of debt stress in lower income credit markets have been preceded by high growth rates among existing institutions, fed by rapid increases in available commercial financing. Commercializing microlenders have often scaled up (in both overall portfolio and loan size) at the same time as commercial banks have attempted to go down market by providing smaller loans to either businesses or consumers. Aggressive competition among lenders for the same client base can saturate market segments quickly. See Figure 1.

The typical phases of expansion and contraction are as follows:

- *Phase 1—Preconditions for expansion.* A few pioneer institutions develop cost-effective lending methodologies to reach underserved or lower access customer segments. This includes low-cost models for client selection, loan disbursement, loan administration, information technology, and effective collection processes.
- *Phase 2—Commercialization and expanded access to funding.* Demonstrated success attracts new entrants. Distribution networks develop further, often involving agent or broker networks and aggressive incentive structures to drive growth.<sup>5</sup> High returns attract commercial investors and enable growth, which in turn requires rapid growth

<sup>4</sup> This section applies to consumer credit markets and Minsky's (1992) analyses of the swings in financial systems between robustness and fragility, with debt build-up followed by over-indebtedness and credit contraction, which in turn fuel extreme economic cycles. See also Kindleberger's (2005) description of financial crises and credit cycles. Such credit cycles have received much attention since the global financial crisis, particularly as the basis for macroprudential (as opposed to microprudential) or counter-cyclical policies that operate to curb credit cycles. See, e.g., Bank of England (2009).

<sup>5</sup> MFIs had access to relatively ample new sources of debt in Bosnia–Herzegovina, Pakistan, Nicaragua, and Morocco during the period (2004–2008) before their default and repayment crises. See Chen, Rasmussen, and Reille (2010). Leading up to the U.S. subprime crisis, the linkage between mortgage brokers and securitization enabled a similar pace of expansion through new capital sources.

in loan portfolio and market share to achieve expected returns.

- *Phase 3—Debt build-up with high borrower liquidity and low defaults.* As the market enters a phase of rapid growth, competition could undermine lending standards and processes. Borrowers may have access to multiple loans from different lenders, enabling them to “borrow from Peter to pay Paul.” The high level of liquidity means that defaults may remain surprisingly low for an extended period even as overall debt levels increase.
- *Phase 4—Escalating default and contraction.* Defaults start escalating, triggered by unsustainable household debt levels and sometimes by external shocks, such as economic slowdowns. Lenders become alarmed, start cutting back on new credit, and prioritize debt collection. This contracts household liquidity, leading to escalation of defaults.
- *Phase 5—Institutional failure and potential for contagion.* Default levels may affect several lenders, including banks, whether as a result of their own lending or as a result of providing loan capital to retail lenders. Depending on the level of bank exposure, this could result in bank failure.

*Debt stress appears as a warning sign, but also as a sign of the success of previous strategies for credit expansion and financial inclusion.* The challenge lies in developing appropriate regulatory strategies that deal proactively with the consequences of increasing credit access, rather than trying to roll back commercialization.

### **Causes of debt stress: Lender practices and borrower behavior**

Regulations and policies must address the individual behaviors that collectively contribute to the credit cycle. The lending strategies and specific loan policies adopted by individual lenders play a determinative role in the credit cycle. Every lender effectively determines the amount of debt that will develop in its

client base over time, through its selection of a target market, growth targets, affordability assessment and credit criteria, and loan officer incentives structure. Certain lending methods, such as payroll-deducted lending, unsolicited credit, or automatic/incremental re-advances, will cause an increase in debt build-up and can increase the risk of debt stress. (See Annex 2 for more on microcredit methods and risks.)

Traditionally, regulators assume that the risk of default should keep lenders from providing further loans to clients who are at risk of becoming over-indebted. Unfortunately, several factors undermine this assumption. A high-interest-rate environment, or one that allows significant late payment penalties or debt collection charges, creates incentives for high-risk lending.<sup>6</sup> As long as the return on increased lending (including all interest, fees, and potential late payment penalties on clients with irregular payment patterns) is sufficiently high to offset the capital losses on defaults, a lender can withstand a high level of arrears while still maximizing its return across the total portfolio. (See Annex 1 for variations in microcredit.) High late-payment interest and penalties or debt collection fees increase the profitability of lending to clients who have a high likelihood of going into arrears, creating an incentive to target borrowers with weak repayment records.

Obviously, the “financial imprudence”<sup>7</sup> of the client base also plays a role in debt stress, as does “desperation borrowing” by clients who rely on loans to augment very low or unstable incomes. However, research indicates that factors such as reckless borrowing or borrowing with the intention to default do not constitute a significant cause of over-indebtedness.<sup>8</sup> Low-income or vulnerable households are quite likely to face situations that cause additional borrowing in response to a household crisis or external event (e.g., a reduction in remittance flows). A final factor is that lenders may exploit borrower vulnerabilities and behavioral

<sup>6</sup> See, e.g., Gardner (2010).

<sup>7</sup> In the United Kingdom, e.g., credit counselors point to factors such as low financial literacy levels and cognitive biases in consumer choices as underlying what may look like irresponsible behavior (over-borrowing, under-insurance); they cite such “financial imprudence” as a main factor in over-indebtedness (Disney, Bridges, and Gathergood 2008).

<sup>8</sup> See, e.g., Disney, Bridges, and Gathergood (2008).

**Table 2. Examples of Lender Practices That Increase the Risk of Debt Stress**

Unsolicited/pre-approved credit	Unsolicited and pre-approved credit create a natural incentive for increasing debt levels among performing clients. This cycle terminates only when the client starts showing signs of debt stress. Automatic increases in loan sizes or credit limits have a similar effect.
Payroll deductions	Permitting loan repayments to be deducted directly from salaries undermines the lender's incentive to assess the borrower's total level of debt, including loans from lenders without payroll deduction facilities. Instead, it creates an incentive to lend to the maximum deduction allowable. <sup>a</sup>
Penalties on arrears	Excessive late payment penalties create an incentive to lend to clients with existing high debt levels.
Hidden fees and charges/weak disclosure	Hidden fees and charges and weak disclosure undermine clients' ability to assess the repayment obligations and manage their own debt commitments.
Loan officer, agent, or broker commissions	High agent or broker commissions create an incentive for aggressive loan origination. The position is aggravated when commission structures do not penalize poor loan quality or subsequent default.
Unregulated debt collection practices	Unregulated debt collection enables predatory lenders to use coercive pressures to enforce repayment and avoid default, even when clients are over-indebted.
No or inadequate credit information sharing	In the absence of credit bureaus, lenders have insufficient information on the total debt levels of applicants. Negative-only bureaus <sup>b</sup> or bureaus that cover only bank credit undermine the effectiveness of credit bureau information.

a. Any mechanism that provides lenders a preference to collect directly from a borrower's bank account for a specific category of lender would have the same adverse outcome. Preferential deductions for credit insurance policies, either from salaries or from bank accounts, are similarly damaging.

b. Negative-only information results in the lender not having access to information on all the loans that are outstanding and thus being unaware of an increase in borrowing until the borrower starts defaulting.

biases<sup>9</sup> through misleading marketing or aggressive sales techniques. Pre-existing high debt levels can make households or consumer credit markets much more vulnerable<sup>10</sup> to adverse shocks, such as job loss, business or crop failure, a death or illness in the family, or divorce, that cause a sudden reduction in household income or an unexpected increase in expenses.<sup>11</sup> The most damaging shocks are those that affect a whole region or population segment, such as a drought or a regional decline in remittance income.

Table 2 provides an overview of different lender practices that create perverse incentives and increase the risk of unsustainable credit growth and unhealthy business models. The regulatory interventions that target these practices are discussed in detail in "Section III. Regulatory and Policy Interventions."

## II. Early Warning Indicators and Monitoring

Keeping these dynamics in mind, market monitoring is the necessary first step in any proactive and integrated approach to curbing debt stress. In this section we provide an overview of early warning indicators and mechanisms regulators can use to monitor debt stress. (The next section explores regulatory mechanisms as well as market infrastructure, such as credit bureaus, to mitigate the risk of over-indebtedness. A complete list of the monitoring and regulatory options is included in Annex 3.)

Market monitoring focuses on indicators that would help a regulator detect a risk of over-indebtedness at an institutional or sector level,

<sup>9</sup> For a survey of some of this behavioral research, see Schicks and Rosenberg (2011) at 16–17.

<sup>10</sup> E.g., already increased indebtedness in the microfinance markets in Bosnia–Herzegovina before the global financial crisis made the country vulnerable and exacerbated the impact of the financial crisis and contributed to the repayment crisis (Leshner and Frachaud 2010).

<sup>11</sup> Research from the United Kingdom suggests that the three key factors that "expose households to the risk of excessive debt and other financial problems are loss of employment (including the failure of a business), marital breakdown, and poor financial management by the household" (Disney, Bridges, and Gathergood 2008).

rather than only at the individual household level (U.K. Task Force on Tackling Over-Indebtedness 2003). Traditional indicators, such as the aggregate debt-to-income ratio or the level of arrears in individual institutions, are often misleading and may not provide an accurate indication of the extent of over-indebtedness in the market. Early warning indicators and other proactive monitoring mechanisms can reduce both risk to the financial system and risk to regulators' credibility.

### Limitations of traditional indicators

Traditionally, a low level of arrears is seen as a strong indicator of low debt stress. However, high household liquidity created during a phase of expansion and growth and rapidly increasing loan portfolios and client numbers (often coinciding with new lenders entering the market)<sup>12</sup> can disguise the level of debt stress. Furthermore, if a portfolio with a mix of small and large loans is not disaggregated by loan size and client segment, household debt problems will show up in regulatory reports only when a very large number of clients are already over-indebted.<sup>13</sup>

There are similar weaknesses in other macro-level indicators traditionally used by regulators. The aggregate debt-to-income ratio is often used as a measure of indebtedness, yet it may be quite misleading. The profile of the underlying debt (the mix between long- and short-term debt and mix between small and large loans) in any particular country has a huge impact on the interpretation of the debt-to-income ratio. The core of the problem is that the debt-to-income ratio is based on the amount of debt, rather than the debt servicing commitment or the number of consumers affected. When the average repayment term of the loan in

a country or portfolio is shorter, a low debt-to-income ratio will mask the true debt stress (the debt servicing ratio is a better indicator).

A general weakness in traditional indicators is the extent to which aggregated indicators or national averages are used. Disaggregated statistics and the trends in these statistics for different income groups, different regions, or different employment categories can help to detect localized stress and prevent problems from being hidden in national averages.

### Early warning indicators

A range of potential indicators can complement traditional credit risk indicators and provide more effective early warning when the risk of debt stress is increasing. The most generally applicable include the following:

- **Rapid growth**—High growth of a lender's portfolio over several years,<sup>14</sup> especially when concentrated in particular market segments, should be cause for further investigation. The risk is increased when the growth takes place across several institutions with a large number of new entrants targeting the same market segment. These risks are exacerbated if there is no credit bureau system through which credit providers can assess an applicant's overall exposure to all lenders and no requirement to do affordability assessments.
- **Increases in loan size/term and refinancing**—A rapid increase in lenders' average loan size and loan term combined with increased refinancing and rescheduling indicate that client debt levels are increasing. When the level of refinancing and rescheduling starts increasing, it is likely that debt stress has reached an advanced stage.

<sup>12</sup> Low-income households may make significant sacrifices to repay loans. For such borrowers, high levels of debt stress (measured by unacceptable sacrifices or compromises to welfare) would not show up in arrears. In such circumstances, household surveys may be an important way to measure debt stress (Schicks 2011a).

<sup>13</sup> For further discussion of the weakness of arrears reports as an indicator of existing debt stress, see Schicks and Rosenberg (2011).

<sup>14</sup> There is no rule of thumb to judge what rate of growth is too high without detailed understanding of context. Note that in the case of microcredit, Gonzalez (2010) finds that growth rates of *individual* lenders show little correlation with subsequent collection problems. However, risk appears to increase when either *aggregate* market growth or microcredit market penetration is very high.

- Increasing debt collection activity and abusive debt collection practices—These practices suggest a high level of debt stress, as does an increase in the volume of court cases related to debt.<sup>15</sup>

None of these signals alone is a certain sign of over-indebtedness. However, a sustained upward trend in more than one of these early-warning indicators may well signal that regulators should gather additional information to assess the extent of the problem.

A common challenge in many early-stage credit markets is limited availability of national statistics and limited resources to commission further studies or surveys. Even where this is the case, there are often alternative sources of information, such as financial statements from regulated entities, credit bureau reports, complaints records,<sup>16</sup> judgment statistics, or less formal sources, such as media reports. Regulators should engage with the national statistics office, department of justice, and other authorities to ensure that appropriate information<sup>17</sup> is collected that would help detect debt stress.

## Monitoring mechanisms

In countries at an early stage of credit market development or with limited formal credit activity, substantial investment in monitoring mechanisms may not be warranted. However, when the level of credit activity increases or when the early-warning indicators raise alarms, deeper investigation and more systematic monitoring may be justified.

Different mechanisms that may be considered include the following:

- Special indebtedness report—If there is a concern about debt stress but no clear statistical evidence, it may be appropriate to commission a special report by a research firm or task team to assess the level of debt stress based on a detailed review of relevant statistics, interviews with lenders, and similar activities. Statistical analysis will help clarify the extent of the problem and determine the level of action that may be required. Such a report has the added value of alerting the industry to the regulator’s concern.<sup>18</sup>
- Special lender reporting—The regulator can require regulated entities to submit a special report on their practices in assessing clients’ levels of indebtedness, and on their views on the extent of debt stress in each entity’s client base, trends in arrears, and causes thereof. This both informs the regulator and raises awareness among lenders, without placing high demands on regulatory capacity.
- Onsite inspection reports—A specific section on lending practices and on indicators of potential debt stress can be included in onsite inspection reports prepared for prudentially regulated entities.
- Test of a sample of lender files—The regulator could choose to evaluate a sample of client files at high-risk lenders<sup>19</sup> to assess the extent of debt stress in the lenders’ client base. Such an assessment is demanding and would be justified only if there is a high level of concern. It is most effective if there is an independent source of information on client indebtedness, such as through a credit bureau

<sup>15</sup> The volume of cases is a more significant indicator than the monetary value of debt-related judgments. Where debt collection happens primarily outside of courts, regulators can look to sources such as complaints reports or the media.

<sup>16</sup> The next section describes two early-stage interventions that can be a source of early-warning indicators while serving other important purposes: (i) setting up systems to receive complaints or complaints reports and (ii) establishing or improving credit reporting infrastructure and participation.

<sup>17</sup> Relevant information could include (i) information on the amount of monthly repayments on debt relative to income, (ii) the number of agreements, (iii) the types of agreements, and/or (iv) the name and type of the lenders involved. It is important that aggregated statistics specify the number of consumers and number of agreements that are involved, and not only the aggregate monetary values. Information on monthly debt-servicing commitments is more important than information on the total amount of debt outstanding. In addition, statistics on the components of the debt (differentiating among principal debt outstanding, accumulated interest, fees, and debt collection or legal charges) would be useful.

<sup>18</sup> In South Africa, both a detailed credit bureau report and a credit provider report are published quarterly, and both reports include statistics that can serve as indicators of debt stress.

<sup>19</sup> High-risk lenders typically would be identified by the appearance of the early-warning indicators in their portfolios, a large number of debt collection cases in the courts, high numbers of complaints filed against them, etc.

## Box 2. Statutory Requirements to Consider Affordability

The following are examples of the formulation of affordability assessment requirements.

### European Union, Consumer Credit Directive, Article 8

#### Obligation to assess the creditworthiness of the consumer

"1. Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer's creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database."

"2. Member States shall ensure that, if the parties agree to change the total amount of credit after the conclusion of the credit agreement, the creditor updates the financial information at his disposal concerning the consumer and assesses the consumer's creditworthiness before any significant increase in the total amount of credit."

### South Africa, National Credit Act

"80. (1) A credit agreement is reckless if, at the time that the agreement was made, or at the time when the amount approved in terms of the agreement is increased, . . .

- (a) the credit provider failed to conduct an assessment . . . irrespective of what the outcome of such an assessment might have concluded at the time; or
- (b) the credit provider, having conducted an assessment . . . , entered into the credit agreement with the

consumer despite the fact that the preponderance of information available to the credit provider indicated that—

- (i) the consumer did not generally understand or appreciate the consumer's risks, costs or obligations under the proposed credit agreement; or
- (ii) entering into that credit agreement would make the consumer over-indebted."  
[*Over-indebtedness is defined elsewhere in the Act.*]

### Australia, National Consumer Credit Protection Act

"131(2) The contract will be unsuitable for the consumer if, at the time of the assessment, it is likely that:

- (a) the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship, if the contract is entered or the credit limit is increased in the period covered by the assessment"

### Mexico, Law on Transparency and Ordering of Financial Services of 2007 (amended through 2010) (unofficial translation)

Art. 18 Bis 1. Entities shall only issue credit, loans or revolving credit card financing upon an assessment of the viability of repayment by the applicants, based on an analysis of quantitative and qualitative information that enables the determination of their credit worthiness and ability to repay.

system. (South Africa's Micro-Finance Regulatory Council regularly performed such assessments. See Box 2.)

- Debt stress task team—The regulator may consider establishing a task team that includes industry representatives and economists, with a mandate to assess debt stress and to develop proposals. In addition to raising industry's awareness of the regulator's concerns, this high-profile step can help the regulator develop an appropriate regulatory response while managing political pressure.<sup>20</sup>
- Annual debt-stress reviews—In high-growth markets, the regulator may consider including a

special section in its annual reports that assesses and comments on the level of debt stress.

- Loan officer survey—Debt stress could be included as one of the topics in a periodic survey of senior loan officers of banks and other lenders to assess and analyze loan officers' views on key topics. This is of most value if done annually, to reveal trends.
- Credit bureau reporting—Credit bureaus could be required to analyze their data and produce reports on trends in debt stress and other relevant information.
- National survey—Where national surveys are conducted on more general information, the

<sup>20</sup> Such task teams have been used in the United Kingdom, United States, and South Africa, among others.

regulator could advocate for a series of questions to be included that gather information on household debt levels and indicators of debt stress.<sup>21</sup>

### III. Regulatory and Policy Interventions

There is a potential trade-off between regulatory mechanisms aimed at curbing over-indebtedness and the requirements of an *effective financial inclusion strategy*. A strategy that aims to prevent over-indebtedness, but sets such high standards that low-income people and people with irregular sources of income do not qualify for credit would be counterproductive.<sup>22</sup> However, there is ample room for a sensible strategy that strikes a balance between these policy goals. Such a strategy would curb the practices of over-aggressive and predatory credit providers, but should have little impact on lenders that target clients who have limited access to finance or lenders that apply sensible procedures to prevent their clients from becoming over-indebted. Such a strategy would simultaneously curtail unsustainable growth in consumer debt and *increase the stability of the credit market*. It is critical that regulators have a solid understanding of the different lending methods and business models in the market.

The U.S. subprime crisis has given momentum to regulatory and policy reform in this area, with several countries implementing specific measures to curb over-indebtedness. There is no “standard set of measures” to address over-indebtedness. The EU Consumer Credit Directive 2008/48/EC (European Union 2008)<sup>23</sup> is a useful benchmark and includes articles on affordability assessments (article 8), credit bureaus and credit information

exchange (article 9), and disclosure (articles 4–7, among others). The G-20 High-Level Principles on Financial Consumer Protection and the companion report from the Financial Stability Board are likely to lead to further guidelines in this area.<sup>24</sup>

A comprehensive regulatory strategy would also deal with a number of related matters, such as disclosure, consumer complaints and redress, limitations on unsolicited credit, and debt enforcement rules or debt counseling.

As a first regulatory priority, this paper proposes **curbing market practices that can create an incentive for reckless lending**. These are market practices that undermine a lender’s incentive to assess affordability or that increase the profitability of irresponsible lending. This includes practices such as direct deduction of loan repayments from salaries, excessive late payment penalties, or abusive debt collection practices. A second priority is to **limit practices that encourage unsustainable growth in credit markets**, such as unsolicited credit offers, negative option marketing,<sup>25</sup> or automatic increases in credit limits. It is also important to **improve market infrastructure through credit bureaus and information sharing**. Once these mechanisms are in place, compulsory affordability assessments could be viewed as a follow-on intervention in the event that perverse incentives remain. However, as discussed below, it may be best not to prescribe quantitative limits (i.e., specific debt service-to-income ratios).

Several regulatory and nonregulatory measures that promote consumer protection and improved market conduct more broadly can also contribute to a comprehensive strategy for addressing debt

21 See footnote 19 for examples of relevant information.

22 E.g., strict collateralization requirements or absolute quantitative affordability assessment thresholds may serve as an unwarranted barrier to lower income consumers. Other policy interventions, such as interest rate caps or limits on multiple borrowing, can have similarly unwanted consequences.

23 See also Ramsay (2004).

24 The current G-20 High-Level Principles on Financial Consumer Protection do not deal with over-indebtedness explicitly, but do include disclosure, transparency, and affordability/suitability assessments (“financial service providers should assess the financial capabilities, situation and needs of their clients before agreeing to provide them with a product or service”). The Financial Stability Board’s consultation document on consumer finance protection deals extensively with both over-indebtedness and responsible lending.

25 Negative option marketing offers a product in such a way that the consumer’s failure to respond is treated as acceptance, thus requiring the consumer to affirmatively reject the offer.

stress. For example, debt stress can be reduced through mandatory disclosure of certain types of information that will help prospective borrowers better understand their repayment obligations and total loan costs so they can make informed decisions on their level of debt and repayment commitments. Similarly, rules that require and set standards for effective complaints handling can help with both detection and monitoring of debt stress levels and provide relief for potentially debt-stressed clients. Effective disclosure and recourse are necessary for a comprehensive approach, but alone they are not sufficient to address the risk of over-indebtedness. Interventions aimed at building consumer financial capacity around debt management also are an important complement, but only in combination with more robust measures targeting lender practices.<sup>26</sup> Mechanisms such as debt counseling are unlikely to be justified except in fairly developed markets with significant debt stress.

Many countries have implemented interest rate controls as part of a package of regulatory interventions to curb debt stress, with the intention to prevent borrower exploitation or to avoid a high interest rate environment that can incentivize over-aggressive lending. However, a simplistic or misguided approach to interest-rate control can do damage to credit supply and can limit access to finance. These disadvantages may well outweigh its benefits in curbing over-indebtedness. Limits on multiple loans or limits on loans from multiple lenders similarly can do damage by stifling competition and market development.

Finally, industry codes of conduct and similar self-regulatory mechanisms may be a useful starting point in early-stage markets, avoiding extensive regulatory prescription when the risk of debt stress

is still low. Such mechanisms bring attention to lending practices and standards, which is a useful starting point in developing markets.

The following section provides an overview of different measures that could be considered in regulating over-indebtedness. Annex 1 offers more detail that includes country examples.

### Incentive failures

The priority must be to identify and regulate market practices that create incentives that increase the risk of over-indebtedness. This includes practices that reduce a lender's incentive to do an affordability assessment, or elevate fees to a level where they increase the profitability of lending to consumers who are already, or are at immediate risk of becoming, highly indebted. Examples include payroll deduction facilities (of which public servants are often a primary target, increasing the risk of political backlash), preferences in debit order processing,<sup>27</sup> coercive debt collection practices,<sup>28</sup> and excessive late payment penalties and debt collection fees.

Potential regulatory interventions in these areas may include the following:

- Imposing limits and/or conditions on the collection of loan repayments through payroll deduction facilities (examples include Kenya, South Africa,<sup>29</sup> the Philippines, and Brazil).
- Limiting late payment penalties or debt-collection charges, to avoid incentivizing high-risk lending and to prevent predatory lenders from applying extreme penalties.
- Rules on the conduct of debt collectors to curb abusive practices, such as were part of the

<sup>26</sup> This paper does not address the broader topics of disclosure, complaints handling, and consumer awareness and financial capability interventions beyond noting their relevance in preventing debt stress.

<sup>27</sup> Payroll deductions and debit orders can be convenient for customers and can lower the costs of lending/borrowing; however, experience has shown they can be subject to significant abuse.

<sup>28</sup> For instance, the use of threats, harassment, or public shame, such as was seen in Andhra Pradesh, India, where there were allegations of a spate of suicides among microborrowers.

<sup>29</sup> Treasury regulations passed in 2001 placed limits on payroll deductions from government employee salaries, as well as on the interest that may be charged on such loans. For more information, see Republic of South Africa Public Service Commission (2007).

regulatory response in India following the crisis in Andhra Pradesh.

### Market practices that encourage unsustainable credit growth

Certain market practices, individually and in combination, lead to unsustainable credit growth and create an environment in which debt stress is likely to increase over time. These include negative-option marketing, unsolicited credit, automatic increases in credit limits, and automatic and incremental re-advances or refinancing.<sup>30</sup> In high-growth markets, loan officer commissions and agent and broker commissions often play a part in unsustainable credit growth. India, South Africa, and Nicaragua are some of the countries in which the aggressive lending practices of loan officers and sales agents contributed to increased debt stress, leading to instability, political intervention, or both (see Annex 2 for details).

Potential regulatory measures include the following:

- Prohibit unsolicited credit and negative-option marketing<sup>31</sup>
- Limit or regulate automatic increases in credit limits (e.g., increases in overdrafts or credit facilities) or on incremental re-advances (e.g., by requiring demonstrated repayment capacity through a new affordability assessment)<sup>32</sup>
- Review commission structures for loan officers and agents, potentially imposing limits or requiring

that commissions be linked to loan origination standards and loan performance<sup>33</sup>

- Introduce explicit accountability of lenders for the conduct of their agents<sup>34</sup>

### Compulsory affordability assessments

An increasing number of countries have introduced a statutory requirement to perform affordability assessments in recent years.<sup>35</sup> The EU Directive on Consumer Credit (2008) requires affordability assessments on all consumer credit agreements (including increases in credit limits). Similar requirements have been introduced in the United States (in respect to mortgages through the Dodd-Frank Act), in South Africa, Mexico, Australia, and Uganda, among others.

Affordability definitions typically consist of the following components:

- A requirement to perform an affordability assessment, with exemptions for cases where it is not considered appropriate or where different standards may be applied, e.g., for educational loans,<sup>36</sup> and standards that accommodate the specific characteristics of group-based microcredit<sup>37, 38</sup>
- A definition of the sources of income and expenses that should be considered when doing the assessment
- An indication of minimum information to be considered, i.e., paystips or credit bureau records

30 Many microcredit methodologies control risk by starting with very small loans, and then increasing loan sizes by a set amount as borrowers successfully repay each prior loan. However, in the absence of sound affordability assessment, this practice entails a high risk that clients will eventually take loans that exceed their comfortable repayment capacity.

31 See, e.g., South Africa's National Credit Act (2005).

32 See, e.g., South Africa's National Credit Act (2005); in Mexico, financial institutions may increase credit lines only for customers who have a good repayment history.

33 In Peru, e.g., financial institutions must ensure that performance incentive structures for personnel do not conflict with the management of over-indebtedness risk. SBS Resolution 6941-2008.

34 Problems in agent and broker behavior often result from limited oversight and accountability by the principal lender. If accountability is improved, direct regulation may not be required. This approach has been followed in Brazil, Colombia, and the European Union, among others (Dias and McKee 2010). The Basel Core Principles (revised 2012) also require that banks be accountable for outsourced services.

35 Ramsay (2004) describes a range of mechanisms that different countries either have introduced or are considering.

36 Note, however, that student loans are covered in some regulations, e.g., those issued by the U.S. Consumer Financial Protection Bureau.

37 In many group microlending models, group members play an important part in assessing an individual member's repayment capacity.

38 For lenders making very short-term loans (e.g., three months or less), the requirement of an affordability assessment before every loan might be relaxed somewhat for loans to borrowers with a good repayment history.

### Box 3. The Effect of Add-Ons and Penalty Interest on Loan Repayments

**Example:** A \$500 loan is repayable at 33% over 12 months. Lender charges the following additional fees: (a) 15% loan administration fee, (b) 10% credit life insurance, and (c) 10% penalty interest on late payments.

**Note:** These add-ons are typically excluded from the advertised loan repayment amount, making it impossible for the consumer to understand the impact before taking on the product.

Monthly loan repayment without add-ons	49.48
Monthly loan repayment with add-ons	61.86
Monthly loan repayment with add-ons and penalty interest	68.04

The installment amount thus increases by 25% as a result of add-ons, and by a further 10% if the

loan goes into arrears. Therefore, a loan that looks affordable based on the nominal repayment may be difficult to repay after additional charges. **Penalty interest means that the repayment will increase exactly when the client may be having financial problems, making it even more difficult to recover.** In practice the lenders with the worst standards resort to the most extreme fees and penalties.

**Regulatory proposals:** (a) A simple pre-agreement disclosure form that includes total monthly repayment, inclusive of all fees, charges, or add-ons; (b) advertisements, brochures, or leaflets must show the repayment, including all add-on charges, and must show penalties; and (c) disclosure of and limits on penalty interest, penalty fees, or debt collection charges.

(such standards should be sufficiently flexible to be applicable to people with informal sector or irregular sources of income)

Box 2 summarizes the legal definitions that are applied in a few countries.

Pressure is often put on regulators to define a specific “affordability percentage” (e.g., a ceiling on the allowable borrower debt-service-to-income ratio). However, there are strong arguments against such an approach. The primary concern is that the level of affordability strongly depends on the target market of each lender, its credit risk policy, and the length of the repayment term. It is difficult to define one specific percentage that would be appropriate for all types of lenders, all types of products,<sup>39</sup> and all the different segments of the potential client base. In general, this should be left to the discretion of each lender.

### Disclosure and transparency<sup>40</sup>

Effective disclosure requirements improve the borrower’s capacity to assess total loan costs and the level of repayment commitments relative to expected income. A key requirement is disclosure of the aggregate periodic repayments, including all fees and charges. This should preferably be compulsory and standardized in advertisements, marketing leaflets, and pre-agreement disclosures.<sup>41</sup> Box 3 illustrates the impact of add-ons and fees and the implications of weak disclosure.<sup>42</sup>

The method and timing of disclosure is of equal importance. Regulators may prescribe the timing of disclosures (i.e., sufficiently before a contract), the provision of a clear summary sheet highlighting the most important terms and conditions, and disclosure in advertisements and leaflets as well as oral explanations accompanying written

<sup>39</sup> A long-term loan should, e.g., be subject to a lower limit than what may be tolerable for a short-term loan.

<sup>40</sup> For more detailed discussion, see Chien (2012).

<sup>41</sup> Clear disclosure of the full cost of credit in advertising and marketing material is critical. This allows the consumer to consider full cost of the repayment obligations before engaging with credit providers and to obtain independent advice if needed, avoiding being pressured to making decisions while in discussion with loan officers.

<sup>42</sup> Research has shown that borrowers in some settings have found annual percentage rate less useful than other disclosure methods (e.g., total cost of credit, the cumulative amount to be paid over the life of the loan) (Chien 2012).

disclosures. For instance, Ghana's Borrowers and Lenders Act of 2008 requires all lenders to use a prescribed disclosure sheet that presents the annual percentage rate (APR), total cost of credit, and a repayment schedule and highlights whether certain risky conditions apply. This form includes plain-language explanations. South Africa requires credit providers to disclose the cost of credit in advertisements and brochures and to provide consumers with a pre-agreement quote. Other regulators, such as the Superintendency of Banks and Insurance (SBS) in Peru, require lenders to regularly submit information about the pricing of products, which SBS then publishes to allow for cost comparisons. Disclosures should also include contact information for internal complaints mechanisms and external ombudsman schemes.

### Financial literacy, debt advice, debt counselling, and debt restructuring

Increased consumer awareness and financial literacy and education interventions related to debt stress are designed to make borrowers more cautious when taking on loans. They also aim to help them deal with the consequences of over-indebtedness and debt stress. This may be limited to general warnings on over-indebtedness and the value of good borrowing habits (for an example, see Figure 2) or could extend to topics such as budgeting and financial planning. As noted, such interventions should be seen only as a complement to robust regulations aimed at responsible lender behavior.

Debt advice and debt counseling provide services to consumers who are already over-indebted. The

**Figure 2. Advertisement from Consumer Awareness Campaign Conducted by South Africa National Credit Regulator**

**5 tips for surviving the credit crunch**

## 3. Avoid borrowing to pay off debt

- At all costs avoid using credit cards to pay for existing debt.
- Credit only creates more debt, so don't take on any extra credit cards or store cards.
- If you get retrenched, use the retrenchment package to pay off debt.
- Cut down on unnecessary expenses and luxuries.

the dti  
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service may be limited to debt advice or advice on budgeting and financial planning, or it can extend into full debt counseling, assistance with debt restructuring,<sup>43</sup> and assistance with applications for personal insolvency. Countries such as Malaysia and South Africa have adopted slightly different approaches,<sup>44</sup> largely informed by the extent of credit market development and the level of debt stress in each. In the management of debt stress, the United Kingdom has a rich institutional experience involving public-sector institutions as well as a large private-sector-funded debt mediation mechanism.<sup>45</sup>

<sup>43</sup> In this context, debt counseling and debt restructuring refer to a service that would help consumers negotiate with all the different credit providers to restructure debt. This normally would involve a restructuring of all loan obligations, potentially including interest reduction, extension of payment terms, or capital reductions. Such interventions are typically possible only if the powers are created through specific legislation.

<sup>44</sup> In Malaysia in 2006, Bank Negara Malaysia set up the Credit Counseling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit [AKPK]), which provides free services to individuals. With the 2005 National Credit Act, consumers in South Africa could seek debt counseling from a network of private debt counselors registered with and regulated by the National Credit Regulator.

<sup>45</sup> The Consumer Credit Counseling Service (CCCS) is a world leader in the provision of debt counseling and debt restructuring services. It is a registered charity that functions as an umbrella debt counseling service in the United Kingdom. It is primarily industry-funded and provides a free national telephone service as well as face-to-face counseling through regional centers. In 2011, CCCS provided debt advice assistance to 350,000 consumers (CCCS Research 2012; CCCS Statistical Yearbook 2011).

## Credit bureaus and credit market infrastructure

A credit bureau adds significant value by giving credit providers information that may help to detect existing over-indebtedness, guard against future over-indebtedness, and promote financial inclusion.<sup>46,47</sup> In addition, a credit bureau can lower the credit provider's costs of doing an affordability assessment, enable the lender to reduce defaults, and contribute to lower interest rates to consumers. Finally, a credit bureau can be a powerful market monitoring tool for the regulator.

To be effective, a credit bureau system should include banks as well as consumer lenders, microlenders, and other nonbank lenders, thus ensuring that an inquiry would reflect all formal sector debts. Furthermore, the system should enable collection of both negative and positive (full-file) information.<sup>48</sup> A negative-only register is of limited value and is particularly weak in providing an early warning indicator when the level of debt is increasing but default has not yet occurred. Consensus is building that in a system where both bank and nonbank institutions share in "full file" information, credit bureau reporting can make important contributions to financial inclusion.<sup>49</sup>

For example, credit bureaus in Mexico and South Africa have expanded information collected to

include a much greater share of total lending to the "base of the pyramid" (Lyman et al. 2011). As a result of the reckless lending conditions in the South African legislation, South African bureaus have developed specific indebtedness indicators in addition to the more usual credit scores. Where informal lending is widespread, regulators may look for innovative ways to facilitate more comprehensive reporting, including by informal lenders.<sup>50</sup>

## Codes of conduct, self-regulatory bodies, and industry ombudsman schemes

Self-regulation through an industry code of conduct can be an important starting point in introducing basic lending standards, guidelines for affordability assessments, and similar measures to curb debt stress. The regulator may encourage the establishment of a code of conduct through its engagement with industry associations. In some jurisdictions, supervisors formally oversee implementation of self-regulatory initiatives. The biggest challenge in a self-regulatory approach is to monitor and enforce compliance.<sup>51,52</sup> In addition, even if self-regulation is implemented well, limited coverage might limit its effectiveness—for example, if a significant share of lending remains outside the boundaries of self-regulatory arrangements. Self-regulation could offer a pragmatic starting point for an early-stage, developing market, but would

46 See, e.g., Chen, Rasmussen, and Reille (2010), at pp. 7–8.

47 Credit bureaus can enable credit providers to identify potential clients from client groups that are excluded from financial services, by using noncredit indicators, such as monthly bill payments or monthly rentals of a mobile telephone.

48 "Negative-only" reporting refers to a credit reporting system in which data furnishers selectively report only adverse account information to credit bureaus. This provides bureaus with a partial snapshot of account behavior, but fails to accurately depict the entire credit history. By contrast, "full-file reporting" includes this negative event information, along with many other indicators, such as "account balances, number of inquiries, debt ratios, on-time payments, credit limits, account type, loan type, lending institution, interest rates and public record data" allowing for a fuller and more accurate picture of credit risk (PERC 2009).

49 One study shows implementation of such a system correlating to increases in private-sector lending on the scale of 48–60 percent of a country's gross domestic product (PERC 2009). Such growth, depending on its target markets, can improve access.

50 In Ghana, e.g., a proposal is being considered to have *susu* collectors report to a credit bureau via mobile phone. *Susu* collectors may be thought of as "mini mobile bankers" who circulate among villages and markets collecting deposits from women's *susu* savings groups and individuals. *Susu* collectors have been regulated by the Bank of Ghana since 2011. In South Africa, a data category called "public domain data" enables broad participation in information sharing by both credit providers and other service providers.

51 The "responsible finance" movement, led by the Smart Campaign ([www.smartcampaign.org](http://www.smartcampaign.org)) for the microfinance field, has given new impetus to voluntary adherence to a common set of lending standards; in addition, a third-party certification system to validate compliance was launched recently. Meanwhile, external reviews and assessments by social investors (e.g., microfinance equity funds) create strong incentives for compliance among institutions that depend on such funding.

52 In Senegal, e.g., the regulator mandates membership in the MFI industry association, which strengthens the incentive to comply with the code of conduct for that sector. South Africa offers an example of effective formalization of industry-specific ombudsman schemes through mandatory participation.

normally not be appropriate on its own in a highly commercialized, rapidly expanding, or aggressive lending environment.

Introducing an industry-funded ombudsman scheme can compensate for some of the weaknesses of a self-regulatory approach to the extent that it offers accessible and effective mechanisms for customers to resolve misunderstandings and complaints with some objectivity. The effectiveness of an ombudsman is enhanced if the mandate of the ombudsman is formalized and reinforced by law or regulation.

### Cautionary note on interest rate controls and limits on multiple lending

The political reaction to over-indebtedness often includes interest rate or margin controls, as was the case in India, Nicaragua, and other countries. There are arguments made for and against such a response. On the one hand, a high-interest-rate environment enables lenders to tolerate a higher level of default and thereby creates an incentive to lend to clients who may already be over-indebted. Some argue that interest rate limits might discourage high-risk or predatory lenders from entering the market and would thus reduce lending pressure.

However, there are also several strong arguments against imposing interest rate limits. Primary among these is the high risk of unintended consequences. Interest rate limits based on an all-inclusive APR definition will always have a more negative impact on small or short-term loans.<sup>53</sup> **A blanket interest rate cap could thus reduce the supply of small and microenterprise loans—those that are most needed from a financial inclusion and small/microenterprise development perspective and that may offer better value-for-money than their informal-sector alternatives.** If considered, therefore, interest rate controls should be

1. Based on extensive empirical research on the actual cost of lending

2. Structured to accommodate the reasonable cost of origination and servicing of small loans and microenterprise loans
3. “Tiered” by criteria such as size, term, or security to accommodate the differences in cost and risk among categories such as mortgages, credit cards, unsecured loans, and microenterprise loans

**Similar caution should be exercised regarding limits on multiple lending.** In the wake of various debt-related crises in developing countries, considerable attention has been paid to the extent to which over-indebtedness is caused by clients borrowing simultaneously from different lenders. The possibility of multiple lending, however, is an inevitable consequence of an expanding credit market and can benefit consumers by providing a choice among different credit providers. Furthermore, any single lender might limit loan size well below the borrower’s borrowing requirements and actual repayment capacity. Placing a limit on multiple loans or imposing a requirement that a borrower may borrow from only one lender would undermine competition and consumer choice. Finally, while some studies find a correlation between multiple lending and over-indebtedness, other studies find no correlation or even a negative correlation in one case (Schicks and Rosenberg 2012).

For these reasons, market-based regulations, such as compulsory affordability assessments, establishment of credit bureaus, and mechanisms to address adverse incentives, should be implemented before considering high-risk interventions, such as limits on interest rates or limits on loan sizes or loan terms.

## IV. Prioritization, Sequencing, and Tailoring Interventions to Country Context

This Focus Note offers an overall policy and regulatory framework for preventing and managing debt stress, with select country examples. The selection of a particular set of regulatory or policy

<sup>53</sup> This is due to the inclusion of origination and servicing fees that may be high relative to the size of the loan.

options must be determined by the specific circumstances in each country. In early-stage credit markets with a low risk of debt stress, it would be inappropriate to allocate substantial regulatory resources to over-indebtedness. In contrast, the position will be quite different in many middle-income countries with rapidly expanding credit markets, where attention to over-indebtedness may be a regulatory priority.

Certain market practices have undesirable consequences in nearly every environment. Furthermore, certain institutional developments (such as credit bureaus) are useful even in early-stage credit markets, both from the perspective of promoting sound lending practices and facilitating increased access to finance. As has been emphasized throughout this paper, the introduction of a framework to monitor credit market activity and detect early warning indicators should be a priority in most environments. The experience of recent years indicates that debt stress can not only harm affected borrowers but it can also have serious political repercussions and lead to inappropriate interventions that can undermine many years of credit market development. Ideally, regulators should be the first to detect increasing debt stress so they can implement a credible response before the problem results in newspaper headlines. This would protect borrowers and lenders, reduce the reputational risk to the regulator, and dampen the risk of politically motivated and ill-advised interventions.

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## Annex 1. Detailed Comparative Supervisory, Regulatory, and Policy Interventions

Category of response	Examples of problems and concerns	Examples of relevant regulatory measures	Country examples
<b>Detection and monitoring</b>	<ul style="list-style-type: none"> <li>Debt stress is often detected only by conventional microprudential techniques when it is already at an advanced stage, affecting large numbers of clients and possibly even threatening institutions.</li> <li>Many of the monitoring mechanisms that are normally part of prudential supervision are ineffective.</li> </ul>	<ul style="list-style-type: none"> <li>Identify potential early-warning indicators and monitor trends.</li> <li>Produce an annual report to assess the extent of debt stress and over-indebtedness.</li> <li>Improve national statistical surveys by including appropriate debt-related questions.</li> <li>Include specific checklists and procedures in bank supervision inspection programs.</li> <li>Conduct regular “loan officer surveys.”</li> <li>Conduct special research.</li> </ul>	<p><b>Peru:</b> SBS Resolution 6941-2008 requires financial institutions to regularly and annually test their small-scale borrower portfolio for signs of debt stress and risk of over-indebtedness, report this analysis to directors, and take corrective/preventive actions. The Risk Unit in each financial institution must report quarterly to directors, and this report must be made available to SBS.</p> <p><b>South Africa:</b> The National Credit Regulator is responsible for monitoring and reporting on levels of over-indebtedness and socioeconomic consequences.</p>
<p><b>Incentive structures</b></p> <p>→ Practices that undermine incentive to assess affordability</p> <p>→ Practices that increase profitability of reckless credit extension</p>	<ul style="list-style-type: none"> <li>Payroll deduction facilities</li> <li>Debit order processing preferences</li> <li>Excessive late payment penalties</li> <li>Excessive debt collection fees</li> <li>Abusive debt collection practices</li> <li>Easy access to court orders, without consideration of lender behavior</li> </ul>	<ul style="list-style-type: none"> <li>Impose limits on payroll deduction facilities or limit types of transactions that may be deducted from pay.</li> <li>Implement minimum standards for debt collection conduct. Prohibit abusive conduct.</li> <li>Impose maximum limits on late payment penalties or debt collection fees.</li> <li>Implement minimum requirements for access to court orders that force court inquiry, e.g., lender affordability assessments.</li> <li>Implement maximum limits on court orders related to debt (maximum statutory deductions as percentage of consumer income).</li> </ul>	<p><b>India:</b> 2011 NBFC-MFI Directions (as amended) establish limits on margins; forbid penalties charged on late payments; and permit only noncoercive collection methods (cross-reference to Guidelines on Code of Fair Practices for NBFCs).</p> <p><b>Uganda:</b> 2011 Financial Consumer Protection Guidelines prohibit charging of unreasonable debt collection costs/expenses (§ 6[9]).</p> <p><b>South Africa:</b> The National Credit Act prohibits late payment penalties and defines reckless credit so that inadequate affordability assessments render the debt unenforceable, there is a code of conduct for debt collectors, and most types of payroll deduction facilities are prohibited.</p>
<b>Market practices that encourage unsustainable credit growth</b>	<ul style="list-style-type: none"> <li>Heavy reliance on agents and brokers in loan origination, with high commission structures and limited oversight by principal lender</li> <li>Unsolicited credit and automatic increases in credit limits</li> <li>Automatic and incremental re-advances</li> </ul>	<ul style="list-style-type: none"> <li>Prohibit unsolicited credit marketing.</li> <li>Place limits on automatic increase in credit limits and re-advances, or introduce a requirement for prior affordability assessments.</li> <li>Introduce minimum standards on a lender’s accountability for the conduct of its agents.</li> <li>Impose limits on the level and nature of commissions payable to agents and brokers.</li> </ul>	<p><b>South Africa:</b> The National Credit Act (<i>inter alia</i>) prohibits negative option marketing and limits automatic credit line increases.</p> <p><b>Mexico:</b> Financial institutions may raise credit lines only for customers who have good repayment history and then only based on the customer’s explicit acceptance of the offer. All overdraft fees are also prohibited.</p> <p><b>Peru:</b> Financial institutions must ensure that the performance incentive structures for personnel do not generate conflicts of interest with the management of risks of over-indebtedness.</p>

(continued)

## Annex 1. Detailed Comparative Supervisory, Regulatory, and Policy Interventions (*continued*)

Category of response	Examples of problems and concerns	Examples of relevant regulatory measures	Country examples
<b>Compulsory affordability assessments</b>	<ul style="list-style-type: none"> <li>• Extensive lending without any prior affordability assessment</li> </ul>	<ul style="list-style-type: none"> <li>• Impose an obligation to perform an affordability assessment.</li> <li>• Impose minimum standards for affordability assessments.</li> <li>• Prescribe minimum standards for external documentation that must be considered in the course of an affordability assessment.</li> </ul>	<p><b>Mexico:</b> Financial institutions may only issue credit based on an assessment of customer's creditworthiness and ability to repay.</p> <p><b>Uganda:</b> Providers are prohibited from engaging in "reckless lending," which is defined so as to require (<i>inter alia</i>) some form of affordability assessment.</p>
<b>Disclosure and transparency</b>	<ul style="list-style-type: none"> <li>• Consumers who do not adequately understand pricing or other conditions</li> </ul>	<ul style="list-style-type: none"> <li>• Prescribe information to be disclosed, including standardized pricing terms, focusing on total cost of credit.</li> <li>• Disclosure rules to include advertising, brochures, and pre-agreement statements.</li> <li>• Impose plain language requirement in agreements.</li> </ul>	<p><b>South Africa:</b> Standardized pre-agreement disclosure. Required disclosure in advertisements and brochures. Plain language requirements. Regular compliance audits and surveys.</p> <p><b>Ghana:</b> All lenders must disclose certain information in advance of entering a loan agreement, using a statutory disclosure form.</p> <p><b>Peru:</b> Information regarding pricing and other terms and conditions must be prominently displayed in branches and online. Providers must regularly report pricing information to regulator.</p>
<b>Interest rate controls</b> → <b>CAUTION: HIGH RISK OF REDUCING ACCESS TO FINANCE</b>	<ul style="list-style-type: none"> <li>• Extreme interest rates that create an incentive for reckless lending and attract unscrupulous providers into the market</li> <li>• No competitive pressure to curb interest rates</li> </ul>	<p>** Problem: Unrealistic limits based on APR make small loans unprofitable and drive vulnerable clients to loan sharks. **</p> <ul style="list-style-type: none"> <li>• Requirement to perform an affordability assessment preferable to interest rate controls, as it directly addresses underlying affordability problems without the same unintended negative consequences.</li> </ul>	<p><b>South Africa:</b> Credit providers are subject to a range of interest rate caps (depending on credit type) that are pegged to the bank reference rate, and that were designed following extensive empirical market research.</p>
<b>Limits on multiple loans</b> → <b>NOT RECOMMENDED</b>	<ul style="list-style-type: none"> <li>• Excessive borrowing from different lenders, leading to over-indebtedness</li> </ul>	<p>** Problem: Limits undermine competition, undermine expansion of options, undermine development of market. **</p> <ul style="list-style-type: none"> <li>• Requirement to perform an affordability assessment is a preferable intervention and more effective.</li> </ul>	<p><b>India:</b> Under the 2011 NBFC-MFI Directions, no more than two NBFC-MFIs may lend to same borrower.</p>

(continued)

## Annex 1. Detailed Comparative Supervisory, Regulatory, and Policy Interventions (*continued*)

Category of response	Examples of problems and concerns	Examples of relevant regulatory measures	Country examples
Debt counseling	<ul style="list-style-type: none"> <li>Consumers who have no access to support or assistance and who become desperate</li> </ul>	<ul style="list-style-type: none"> <li>Implement industry-level complaints and mediation mechanisms that borrowers can contact when they experience debt stress.</li> <li>Implement government or independent help-line to provide debt advice.</li> <li>Provide for advice or assistance through <i>pro bono</i> legal services or NGOs.</li> </ul>	<p><b>South Africa:</b> National Credit Act provided for registration of a network of debt counselors to assess levels of indebtedness and mediate between consumers and financial institutions for voluntary debt restructuring. Before debt enforcement, financial institutions must propose to consumers that they seek help from a debt counselor or another ADR body/agent.</p> <p><b>Bosnia:</b> BiH Central Bank has supported and endorsed the work of the nonprofit Center for Financial and Credit Counseling.</p>
Codes of conduct and ombudsman schemes	<ul style="list-style-type: none"> <li>Weak lending practices</li> <li>An increase in aggressive or predatory practices</li> <li>No place where consumers can complain about poor conduct</li> </ul>	<ul style="list-style-type: none"> <li>Work with industry to introduce code of conduct.</li> <li>Ensure that code includes appropriate minimum lending standards.</li> <li>Code should include some monitoring and enforcement mechanisms.</li> <li>Support establishment of an ombudsman structure or other forms of recourse.</li> </ul>	<p><b>India:</b> RBI issued Guidelines on Code of Fair Practices for NBFCs and required each NBFC to adopt its own Code of Fair Practices.</p> <p><b>South Africa:</b> The 2004 Financial Services Ombud Schemes Act provides requirements for industry ombudsmen to obtain recognition under the Act. The National Debt Mediation Association has also developed a Credit Industry Code of Conduct to Combat Over-indebtedness.</p>
Credit bureaus and credit information sharing	<ul style="list-style-type: none"> <li>Growth in prevalence of borrowing from different lenders or multiple borrowing</li> <li>No mechanism to assess total borrowing</li> </ul>	<ul style="list-style-type: none"> <li>Create regulatory structure for credit bureaus.</li> <li>Include both banks and nonbanks in information sharing.</li> <li>Share both positive and negative information.</li> </ul>	<p><b>Nicaragua:</b> A new microfinance regulator (CONAMI) is empowered to establish a credit bureau and all registered MFIs are required to consult this or another bureau.</p> <p><b>India:</b> Under the 2011 NBFC-MFI Directions, no more than two NBFC-MFIs should lend to the same borrower (focused on outcome without clarifying how to obtain information necessary to assess). All loans must be approved and disbursed from central location.</p> <p><b>Azerbaijan:</b> In 2011, the Central Bank expanded its Central Credit Registry to include NBFCs, including MFIs, and made reporting mandatory.</p>

## Annex 2. Debt-Related Crises and Political and Policy Reactions in Diverse Developing Credit Markets

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### Bolivia (1998–1999)

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- *Crisis:* As the small-scale credit market heated up, poor credit discipline and underwriting led to excessive lending, including unsustainable multiple borrowing.<sup>a</sup> Following a sharp economic downturn, rising defaults became highly politicized, with consumer groups even holding a financial regulator hostage. As loan repayment deteriorated, a major MFI and a number of consumer lenders failed.
- *Response:* The regulatory response included credit reporting and caps on maximum debt service for salaried workers (50% of salary).

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### South Africa (1999–2006)

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- *Crises:* After 1992, moneylending and consumer finance expanded rapidly, often targeting salaried workers. Increasing defaults resulted in the failure of two of the banks that focused on low-income household lending. The contagion caused further banking stress, with a major mortgage lender being rescued.
- *Response:* High levels of indebtedness and abusive lending practices first led to the establishment of the Micro-Finance Regulatory Council in 1999 and to the prohibition of the payroll deduction facilities. It subsequently led to the introduction of the National Credit Act in 2005, with reckless lending rules, strict disclosure requirements (advertising and pre-agreement), regulation of credit bureaus, debt counselling, and regulation of interest and fees. The National Credit Regulator now regulates all consumer credit by both bank and nonbank lenders.

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### Colombia (1998–2000)<sup>b</sup>

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- *Crisis:* Unprecedented growth in the housing mortgage market (reaching 8% of GDP) was based in part on a financing system (UPAC system) that became delinked from inflation and made mortgages more accessible through the 1990s. When a recession hit, the portfolio became unsustainable. Housing prices collapsed; the number of past-due mortgages soared from 3.3% in 1995 to 13.6% in 1998 and 18% in 1999. One specialized mortgage bank was nationalized, and others were merged or liquidated. Ultimately, this bank category was eliminated.
- *Response:* In the face of the crisis, the government required financial institutions to repossess houses no matter their value in relation to the outstanding loan. Then in 1999, the Constitutional Court declared the UPAC system unconstitutional and ordered Congress to pass a new housing law. In the longer term, new risk assessment models were imposed and judicial foreclosure was reformed.

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### Bosnia-Herzegovina (late 2008)<sup>c</sup>

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- *Crisis:* Microfinance services expanded rapidly from 2006 to 2008. The repayment crisis coincided with the global financial crisis, which affected repayment capacity. MFIs responded by aggressively writing off loans. By the end of the crisis, the number of clients had returned to 2006 levels.
- *Response:* The response included creating a new credit bureau at the Central Bank with mandatory reporting from MFIs and other lenders. A nonprofit debt counseling center was set up in one of the cities with the highest concentrations of microlending.

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### Nicaragua (2009–2010)

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- *Crisis:* In 2009, widespread reports of multiple borrowing and high levels of indebtedness began to appear. The *No Pago* movement was started, and people blocked highways, attacked MFIs, and harassed loan officers, demanding debt forgiveness and lower interest rates. With vocal support from the president, the movement became increasingly politicized and eroded the repayment culture.
- *Response:* A bill proposed strict interest rate limits, a six-month interest-free grace period, and repayment extensions of up to 4–5 years. In 2011 the legislature passed an MFI law and created the microfinance regulator (CONAMI).

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### India (2010)

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- *Crisis:* A decade of microcredit expansion by diverse lenders including state-sponsored Self-Help Groups, banks, and MFIs, particularly in the state of Andhra Pradesh (AP), resulted in almost 32 million borrowing accounts (estimate end March 2011), just over 100 percent of the number of eligible “financially excluded” households (Micro-Credit Ratings International Limited 2011b). Analysis of the data in AP showed that some of these families had seven to eight loans from all sources and were spending a substantial portion of their gross income on debt service. Amid growing concern about over-indebtedness and reported coercive collection practices and borrower suicides, the state government responded with “draconian” regulations that made microcredit operations virtually impossible and threatened US\$2 billion in loans in AP. In the face of ongoing political attacks, MFI loan repayments dropped to 10%, and banks stopped lending to microfinance companies.
- *Responses:* Following the AP legislature’s action, the Reserve Bank of India (RBI) commissioned the Malegam Committee Report, which resulted in RBI regulations, including compulsory affordability assessments and limits on debt collection practices. A microfinance law that is pending before Parliament would further formalize the legal status of MFIs, including opening the possibility of offering deposit services if certain conditions are met. While collections in AP have remained very low for an extended period, the microfinance sector is recovering and beginning to grow again in other parts of India.

(continued)

## Annex 2. Debt-Related Crises and Political and Policy Reactions in Diverse Developing Credit Markets (*continued*)

### Chile (2011)<sup>d</sup>

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- *Crisis*: From 2000 to 2009, rates of household indebtedness grew from 35.4% to 59.9% debt-to-income, with particular expansion in credit cards and retailer financing. A mid-2011 scandal involving the fourth largest retail credit provider, La Polar, led to its collapse and politicized over-indebtedness.
  - *Response*: The Central Bank has taken steps to extend supervision by the Superintendent (SBIF) to nonbank credit card issuers and retail credit providers.
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a. "Multiple borrowing" refers to "clients borrowing from different types of lenders, simultaneously, to meet their diverse needs."

<http://www.cgap.org/events/day-1-session-4-multiple-borrowing-%E2%80%93-definition-concepts-and-reasons>

b. See Cardenas and Badel (2003); Forero (2004); and Arango (2006).

c. See Bateman, Sinkovic, and Skare (2012).

d. See Jimeno and Viancos (2012) and Banco Central de Chile (2010).

### Annex 3. Debt Stress in the Microcredit Industry

Lending methodologies in microcredit institutions pose challenges to applying usual regulatory prescriptions, e.g., a compulsory affordability assessment. Loans to start-up microenterprises and to very poor families would almost inevitably appear to exceed the repayment capacity of the microentrepreneur or family, particularly if the income expected from the business is disregarded. In solidarity group loans it could be both complex and costly to assess the repayment obligations against the income sources of the individual group members, particularly if an individual's liability for the repayments of other group members is factored in. For those providing microcredit and reaching financially excluded populations, cost-efficiency is extremely important, and lenders would justifiably want to avoid any unnecessary expenses.

Microcredit is targeted at people who are excluded from conventional finance and who,

therefore, should have a lower risk of becoming over-indebted. The payment discipline of low-income borrowers has been an important part of the microcredit experience over the past three decades, and there is a fear that a soft approach to payment obligations could undermine that payment discipline through contagion, especially where loans are not secured by traditional collateral. However, the number of cases of debt stress in countries with relatively high penetration of microcredit in recent years indicates that there is increasing risk. The potential of harm that can result from excessive debt for vulnerable households also calls for caution to avoid debt stress. In assessing the procedures of microcredit institutions, regulators should consider and address the factors that typically characterize microcredit markets, methods, and client base, laid out below.

<i>Microcredit factors</i>	<i>Possible policy/regulatory approach</i>
Market-level considerations	<ul style="list-style-type: none"> <li>• Bear in mind that, where there are low levels of financial inclusion, it may be reasonable for institutions to experience high growth rates.</li> <li>• Increase surveillance for signs of debt stress if several different institutions are targeting the same client segment in the same area.</li> <li>• Monitor average loan size, average repayment period, and the level of rescheduling. If there is an increase in these variables this may be a cause for concern. Monitor arrears rates, disaggregated by region. Assess whether repeat loans, with incrementally higher loan sizes or longer terms, are associated with greater levels of arrears.</li> <li>• Monitor the potential threat as a result of lending by different categories of lenders to the same client base (MFIs, banks, credit co-operatives, money lenders).</li> </ul>
High growth and saturated, highly competitive markets	<ul style="list-style-type: none"> <li>• Where there is aggressive competition among different lenders in the same area, require some form of client information sharing. Initially this may be limited to sharing of lists of clients who are experiencing arrears, although participation in a credit bureau is preferable.</li> <li>• Require that lenders establish a complaints system for clients with repayment problems.</li> <li>• Review large institutions' growth targets.</li> <li>• Review loan officer incentive structures to ensure there is a balance between growth and quality incentives.</li> <li>• Assess whether management considered the risk that repayments could be funded through diversion of other income sources (e.g., remittances, social welfare transfers).</li> <li>• Require lenders to introduce affordability assessments. Be flexible in different approaches by different lenders and in lenders using proxies<sup>a</sup> rather than direct measures of income.</li> <li>• Require lenders to submit an annual report, in which each lender does a self-assessment of the risk of over-indebtedness and of its own procedures.</li> </ul>

<b>Microcredit factors</b>	<b>Possible policy/regulatory approach</b>
Solidarity group lending	<ul style="list-style-type: none"> <li>• Include some form of business plan assessment that could substitute for an affordability assessment into programs.</li> <li>• Ensure lending procedures include an enquiry on existing debt<sup>b</sup> and discussion of debt problems.</li> <li>• Ensure loan staff should do an added assessment if the group experiences regular arrears.</li> </ul>
Irregular income; reliance on household or informal income	<ul style="list-style-type: none"> <li>• Loan officers should assess whether income sources are realistic and reasonable<sup>c</sup> and perform further enquiry if there is a cause for concern.</li> <li>• Set the level of repayments at a reasonable level in relation to estimated family income.</li> </ul>
Automatically increased repeat loans	<ul style="list-style-type: none"> <li>• Recognize that eligibility for repeat loans is a powerful incentive for on-time repayment, which also reduces cost and increases efficiency. However, increasing repeat loans will over time increase the risk of loan size exceeding repayment capacity.</li> <li>• Place a limit on loan increases when repayments become irregular.</li> </ul>

a. Proxies are often more effective than direct measures of income as a result of clients' unwillingness or inability to provide reliable income statistics. Lending programs that have a savings component could use the amount saved as an indication of a borrower's ability to service a higher loan size. The key is that each lender should use sound judgment to arrive at an appropriate affordability indicator within its own context.

b. Clients who want more credit may not reveal their obligations. However, there may be indirect sources of information on clients who are over-committed.

c. Although such assessment may be expensive and unreliable, it may be possible to create proxies that will set parameters for "reasonableness." Such proxies could be set in relation to family size, source of income, etc.





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research support from Megan S. Chapman and valuable input by Katharine McKee and Richard Rosenberg, without which this Focus Note could not have been completed.

The suggested citation for this Focus Note is as follows:

Davel, Gabriel. 2013. "Regulatory Options to Curb Debt Stress." Focus Note 83. Washington, D.C.: CGAP, March.

Print: ISBN 978-1-62696-000-8

epub: ISBN 978-1-62696-002-2

pdf: ISBN 978-1-62696-001-5

mobi: ISBN 978-1-62696-003-9

