Impacts of Flexible Loans on Borrower Behavior and Microenterprise Outcomes in Colombia

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Sector(s): Finance

Fieldwork: Innovations for Poverty Action (IPA)

Sample: 2,475 individuals

Target group: Entrepreneurs Self-employed and microentrepreneurs

Outcome of interest: Citizen satisfaction Business investment Credit balance/repayment Profits/revenues Take-up of program/social service/healthy behavior

Intervention type: Credit

AEA RCT registration number: AEARCTR-0001123

Partner organization(s): Santo Domingo Foundation, Kiva, Google.org

Traditional loan products often have rigid repayment terms which may discourage microentrepreneurs from availing themselves of funds that they could invest in their businesses. Researchers conducted an evaluation with new clients of a microfinance lender in northern Colombia to determine the impact of a flexible loan product on repayment behavior, business outcomes, and client satisfaction. The results showed that the flexible loan, which offered payment deferrals, led to some shifts in investment behavior but had no average impact on revenue or profits, and led to higher default.

Policy issue

Microenterprises struggle to grow due to unreliable and inconsistent income streams, which make them vulnerable to unanticipated shocks. The expansion of microfinance lenders has made credit lines more accessible to microentrepreneurs. However, many lenders require fixed and frequent repayments that begin as soon as a loan is disbursed. Such rigid terms can discourage microentrepreneurs from borrowing funds that could be used to make productive investments in their businesses. Indeed, previous research has shown that classic microcredit products have had limited positive effects on the income and growth of the average borrowers, primarily benefiting those who have more experience. Could offering additional flexibility in loan repayments improve business outcomes for first-time borrowers?

Context of the evaluation

In Colombia, microenterprises make up more than 90 percent of the country’s business ecosystem, producing around 40 percent of the country’s GDP and 65 percent of its employment.[1], Barranquilla and Cartagena, where the evaluation took place, are among the top twelve cities in Colombia where it is easiest to start a business.[2]

Researchers partnered with Fundación Mario Santo Domingo (FMSD), a nonprofit organization that supports microenterprises in northern Colombia by providing microfinance loans to local entrepreneurs. When the study began, FMSD had a client base of around 6,000 business owners.

The clients who participated in this evaluation were all new clients of FMSD. Both men and women business owners who were taking out loans for either operational expenses or business assets participated. To be eligible for a loan with FMSD, borrowers needed to have had a business for at least six months, a good credit rating, and no more than one other loan with another institution.

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Details of the intervention

Researchers partnered with FMSD to conduct a randomized evaluation to determine the impact of a flexible loan repayment contract on client satisfaction, repayment behavior, business outcomes, and household outcomes. Together with FMSD, researchers created a loan contract that enabled clients to postpone principal payments without sanctions. A borrower was offered one payment “pass” every four months of their loan duration that could be used at any point during their repayment period, including sequentially. By using a pass, borrowers could extend their loan duration by one month or choose to pay the amount due within their loan duration.

Researchers randomly assigned entrepreneurs inquiring about a loan with FMSD for the first time to different groups in two stages. In the first stage, FMSD randomly offered either a standard loan or flexible loan contract. In the second stage, clients who originally received a standard loan contract offer and applied were then randomly offered the option to switch to a flexible contract. All clients that had the option of switching to a flexible plan accepted the offer.

Thus, participants joined one of the following randomly assigned groups:

1. *Standard group (comparison group, 922 participants)*: Participants in this group received an offer for a standard loan contract and remained on this plan.
2. *Flex group (582 participants)*: Participants in this group received only a flexible loan contract offer.
3. *Standard-to-flex group (971 participants)*: Participants in this group initially received a standard contract offer. After applying and being approved for the loan, they received a randomized offer to switch to a flexible contract and accepted.

Researchers collected and analyzed self-reported information on clients' household and business characteristics, administrative records on loans and client repayment, phone survey data on client satisfaction, and follow-up survey data on borrower behavior, household outcomes, and business outcomes. Participants completed an in-person follow-up survey about 10 months after receiving their loans.

Results and policy lessons

Examining who takes up flexible loans as well as the impact of a flexible loan, the results show no evidence that the types of (potential) clients who applied for and received a flexible loan, which offered payment deferrals, are different from those who applied for and received a standard loan, limiting the prospects of the lender to use flexible loans to increase their client base. At the same time, the results show that the flexible loan led to some shifts in investment behavior but had no average impact on revenue or profits level or variance, and led to higher default.

Loan applications: Clients who received a flexible loan offer were not more likely to apply for a loan than clients who received a standard loan offer. This result implies that there were no additional microloan borrowers who would reject a standard loan offer but accept a flexible loan offer. Thus, lenders would not increase their client base by offering more flexible loans.

Use of repayment passes: On average, clients used 0.57 passes. Further, 33 percent of clients used at least one pass, 18 percent used exactly one pass, and 8 percent used the maximum number of passes allowed. Pass use was low at the very beginning of the loan, suggesting that borrowers were not interested in postponing loan repayments for the purpose of making riskier initial business investments. Rather, researchers observed that clients used their passes to manage business or household cash flow or to take up smaller business opportunities as they arose.

Repayment behavior: Compared to clients in the standard group, flexible group clients failed to repay larger portions of their loan. On average, clients on a flexible contract defaulted on 13 percent – 3 percentage points more than the standard group – of their principal loan amount a year after the original maturity of their loans.

Business outcomes: Being on a flexible loan contract did not have large impacts on microentrepreneurs' sales, profits, or investments, aside from inducing borrowers to shift a part of their business activity from primary to secondary businesses. Loan type also had no impact on whether borrowers took out another loan or worked more hours a day.

Client satisfaction: Flexible loan clients were 7 percentage points more likely (96 percent) than standard loan clients to indicate that FMSD provided "good or very good service quality" and 14 percentage points more likely (14 percent) to attribute good service to the flexibility of the loan product. They also said they experienced less feelings of nervousness or stress.

Motivated by the experience with the new flexible loan introduced as part of the evaluation, FMSD began offering modified flexible loans. However, repayment flexibility was not directly extended to clients. Instead, flexibility was given to credit officers, who were empowered to use a pass on a client's behalf when the client defaulted due to unforeseen circumstances. This policy shields microenterprises from shocks, but may not encourage entrepreneurs to make investments towards expanding their business.

Brune, Lasse, Dean Karlan, and Xavier Gine. "Give Me a Pass: Flexible Credit for Entrepreneurs in Colombia." Working Paper,

November 2022.

1. OECD. 2022. “Financing SMEs and Entrepreneurs 2022: An OECD Scoreboard.” *OECD Publishing.* https://doi.org/10.1787/e9073a0f-e
2. World Bank. *Doing Business in Colombia 2017*. Washington, DC: World Bank, 2017. https://subnational.doingbusiness.org/en/reports/subnational-reports/colombia. License: Creative Commons Attribution CC BY 3.0 IGO