Insight

Financial literacy

Client financial literacy is generally low. It is not automatically achieved with financial access and it needs deliberate financial education measures to improve.

Rationale

Henley Business School and MicroFinanza Rating would like to contribute with a client level research to the analysis of financial literacy and its implications.

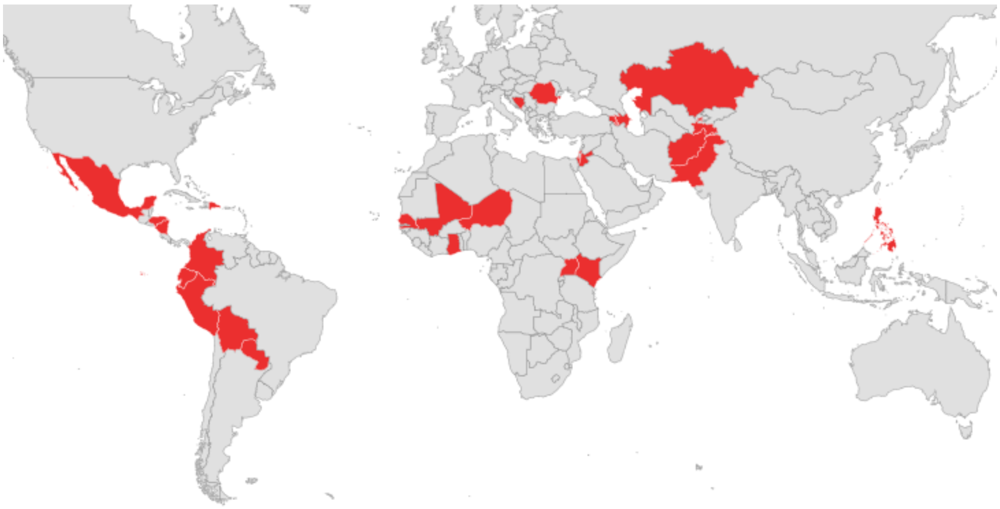
Source and methodology

Henley Business School, University of Reading

MicroFinanza Rating

Henley Business School (University of Reading) carried out a research on the relationship between financial literacy, clients' socio-economic profile and financial access profile.

Data: 9,053 clients, 52 FSPs, 28 Countries
Social Rating field surveys



- Financial literacy: the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources (Giesler, Markus). One of the skills is interest rate awareness.
- **Interest rate awareness**: clients who know their nominal interest rate within 25% margin of error.
- Limitations: one measure of financial literacy only, no causation.
- Logit model:

$$\textit{Interest rate awareness} = \alpha + \beta\_1 \text{ x } \textit{Sociodemograhic Status} + \beta\_2 \text{ x } \textit{Financial Access} + \varepsilon$$

Research questions	1: Where do we stand in financial literacy? 2: What borrower profiles are more financially literate? 3: Are borrowers with previous financial access more financially literate?

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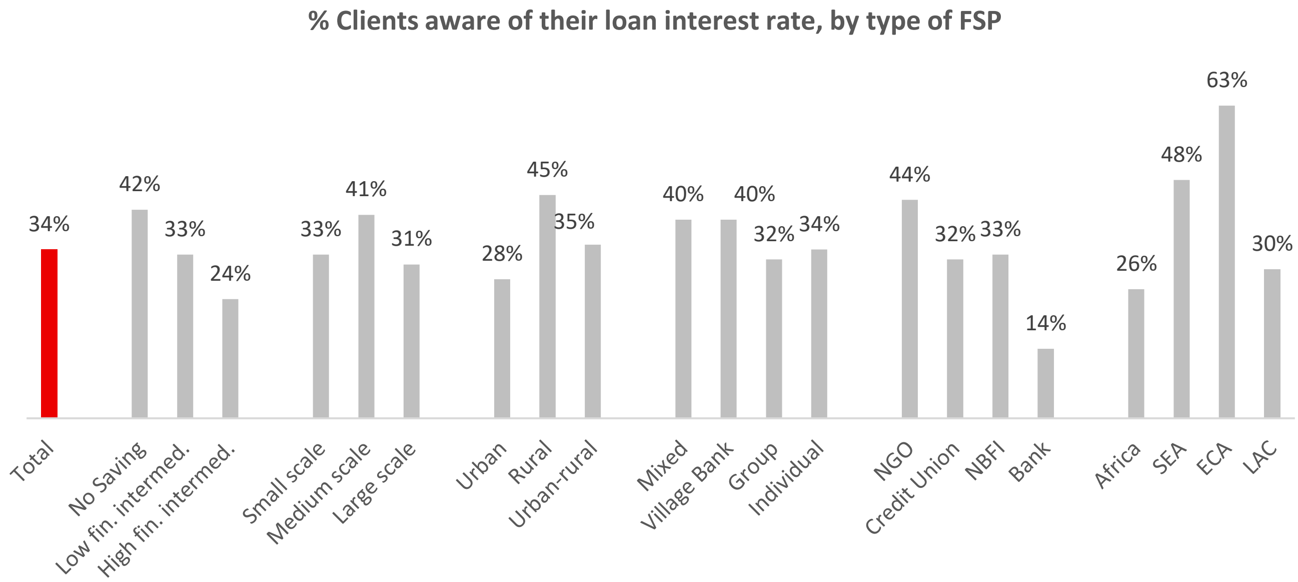
Level of interest rate awareness

Literature reveals that many borrowers do not know what interest rates were charged (Moore 2003; Lusardi 2011), even in the traditional financial sector. Low levels of financial literacy are prevalent everywhere. The microfinance industry is no exception. The microfinance data sample shows that the **borrowers' interest rate awareness is very low**: only 34% of the borrowers can tell what is the nominal interest rate on their loan, even allowing a large margin of error. This is observed across the board, including bank clients, urban clients and clients of Financial Service Providers (FSP) successful at mobilizing savings (high financial intermediation).



NBFI: Non Bank Financial Institution

Social and financial access characteristics associated with financial literacy

The key results and non-results of the logit regression model are presented below:

- **Socio-demographic profile**: as in previous research, younger and better educated borrowers show higher interest rate awareness. However, unlike other results in literature, gender does not appear to be significant and clients living in rural areas demonstrate to be more aware than those living in urban areas.
- **Financial access profile**: surprisingly, the association of interest rate awareness with previous access to formal sources of credit (either banks, NBFIs, Credit Unions or NGOs) is not significant: formal credit experience does not seem to necessarily increase future financial literature. However, the experience with informal sources of credit seems to do it: borrowers with previous loans from moneylenders, family and friends display a higher awareness of the interest rate of their current loan, maybe becoming more sensitive after stressful experiences. The significant relation between higher nominal interest rates and lower client awareness of the interest rate itself may trigger questions about how transparently cost information is provided to clients, especially when interest rates are high. Lower awareness of interest rates in clients with multiple borrowing from several sources may suggest that the inability of making informed and effective decisions is at the roots of client over-indebtedness. The negative relationship between client awareness and the fact of having previous access to saving services is quite puzzling and should be better studied, but it may already indicate that the saving remuneration as it is predominantly done (or not done) in microfinance may not be central for client financial skills development.

Variables associated with client awareness of interest rate, results from logit regression

Dependent variable	**Client awareness of interest rate**	
Controls	Country, survey year	
Socio-demographic explanatory variables	Age*** Education*** Client household head*** Living in rural area*** Female	↓ ↑ ↑ ↑ –
Financial access explanatory variables	Annual interest rate on current loan*** Multiple borrowing from other NBFI, NGOs, Credit Unions (now)*** Have a saving account (previously)*** Have a loan from moneylender, family or friends (now)*** Have a loan from NBFI, NGO or Credit Unions (previously) Have a loan from bank (previously)	↓ ↑ ↓ ↑ – –

***/** Statistical significance at the 1%/5% level.
↑ variable associated with higher interest rate awareness.
↓ variable associated with lower interest rate awareness.
– variable without significant association with interest rate awareness.
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The initial hypothesis are partly validated and partly rejected:

Hypothesis 1 Sociodemographic factors such as gender, age and education level are associated to the financial literacy levels of clients in the cross-country microfinance environment.	**√** Age, education **X** Gender, rural
Hypothesis 2 Clients with previous access to credit and additional source of credit have higher financial literacy of interest rate.	**√** Previous access to moneylenders, family and friends **X** Previous access to banks, NBFI, NGO or Credit Unions; multiple borrowing

Implications

More research should be conducted on the complex topic of microfinance clients financial literacy. The research allows formulating some initial discussion points:

- Financial literacy may not be automatically achieved with access to finance; deliberate financial education measures are needed to improve it.
- Given the cost of education programs, it may be cost-effective to take financial education measures with target segments with especially low financial literacy.
- Transparency culture and supervision could help improving client financial literacy.
- Client financial literacy may be a necessary line of defence against over-indebtedness.