PRAKARSA Policy Brief

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The Risk of Over-indebtedness Amid COVID-19 Pandemic

Key Points:

- Over-indebtedness makes households more vulnerable amid COVID-19 pandemic. Job losses and economic slowdown are making it increasingly difficult for households to meet their financial obligations.
- In Indonesia, rising household debt is partly driven by an increase in the number of credit card holders and online peer-to-peer (P2P) lending borrowers. The number of credit card holders increased from 12 million in 2009 reaching 17,28 million in 2019. Meanwhile, P2P lending continues a significant growth with around 647 thousand lenders and 24,7 million borrowers in April 2020.
- Broader access to financial services has not been followed by sufficient effort in providing financial literacy and education. Financial inclusion index reached 76% while financial literacy index has only reached 38%. This gap indicates the potential risk of over-indebtedness which might cause negative impacts on both microeconomic and macroeconomic level.

Source: Macrovector

Household Over-indebtedness During the Pandemic Era

Large Scale Social Restrictions (PSBB) due to COVID-19 pandemic has directly impacted business and caused massive layoffs. The Ministry of Manpower reports that the pandemic affects at least 3,05 million workers (Tempo, 2020). In the meantime, economic slowdown has caused a decline in household income. As a consequence, many households are at significant risk of over-indebtedness due to the difficulty in servicing their outstanding debt.

Household spending holds an important role to the national economy. Evidence from prior financial crises suggest that household financial vulnerability, particularly on the build-up of household debt, intensifies the recessionary effect of a crisis. This was evident during the 2008 financial crisis when subprime mortgages in the United States started defaulting in an ever-increasing rate. Interdependence between household economy and the financial sector means the need to protect households from financial risks and vulnerabilities, especially against financial distress caused by the inability to meet financial obligations

In Indonesia, the rise of peer-to-peer (P2P) lending and credit cards transactions has increased the number of household debts. The trend over Indonesia's household debt remains growing. According to CEIC (Census and Economic Information Center) data, household debt grew by 26 percent from 2015 to 2018. In nominal terms, household debt increases from 83,33 million US Dollar or equivalent to 1,14 trillion rupiah to 105,14 million US Dollar or equivalent to 1,44 trillion rupiah. In December 2018, the ratio of household debt to GDP (Gross Domestic Product) consistently increased, reaching 10,27 percent from 8 percent in 2010.

Based on the Central Bank of Indonesia (BI), there were 12,2 million credit cards in circulation in 2009. This number reached 17,4 million credit cards in 2019. Although the number of new credit card holders stagnated over the recent years, credit card transactions continue to grow. In 2019, BI payment statistics recorded an increase of 3,2 percent in credit card transactions to 349,21 million transactions, where in nominal terms credit card transactions surged by 9 percent to 342,68 trillion rupiah from the previous year. Digital transactions is the main contributor to this growth. Indonesia is Southeast Asia's largest digital economy with a transaction value of 41 billion US Dollar in 2019. This number is projected to reach 134 billion US Dollar by 2025 due to e-commerce, online travel, online transportation, and online media transactions (Google, 2019).

On the other hand, P2P lending emerges as a solution to fill the relatively high financing gap in Indonesia. Around 71 percent out of 186 million of middle to lower income individuals and 74 percent out of 63 million Micro, Small, and Medium Enterprises (MSMEs) do not have access to credit (PWC, 2019). This situation allows technological innovation to provide an easy and affordable source of alternative financing. Financial Services Authority (OJK) reports that as of April 2020, P2P lending loan disbursement achieved an accumulative value of 106,06 trillion rupiah, an increase of 186,54 percent (yoy) while the number of borrowers increased by 218,75 percent (yoy) to 24,7 million accounts.

Economic uncertainty surrounding the COVID-19 pandemic has caused many households to suffer revenue loss. Households are urged to find an alternative source of financing to fulfill their own necessities and financial obligations. This induces households to switch from conventional credit to P2P lending which potentially increases the risk of over-indebtedness. Moreover, lack of financial literacy has trapped many consumers into an ecosystem of illegal P2P lending who cleverly seduces its consumers with the lure of 'easy and fast' loan terms. As of 2018, the Investment Alert Task Force (SWI) has uncovered 2.486 illegal P2P lending companies. From January to April 2020, SWI uncovered 508 illegal P2P lending companies. This number is far greater than the 161 legal P2P companies that have officially registered to OJK (CNBC, 2020). The illegal P2P lending cunningly takes the advantage of the economic crisis by offering short-term high interest credit to illiterate households with urgent financial needs (Kompas, 2020).

The Household Debt Time Bomb

In the short term, household debt is going to boost consumption and GDP growth. However, household debt is going to affect the economic stability over the long-run (IMF, 2019). "A 5 percent increase in the household debt to GDP ratio over a three-year period is expected to lead to a 1,25 percent drop in real GDP growth three years ahead" (The Asian Banker, 2018). This illustrates that rapid growth in household debt will make a country more vulnerable towards economic shocks.

Sutherland et.al (2012) suggests that consumption volatility excels when household debt is high and over-indebted borrowers tend to over-consume. On the other hand, over-indebtedness is going to affect the business cycle over the long-run. Household expenditure is interpreted by the business sector as stronger household purchasing power which will drive production and labor output. However, the strong purchasing power is not going to last long since it does not come from effective demand but is rather fueled by debt. When debt-driven consumption continues to grow, it will eventually reach a saturation point when over-indebted households could no longer afford any more debt to finance their consumption.

Hunt (2018) confirmed that over-indebtedness affects the economy especially during a recession. According to Hunt, the financial pressure from over-indebted households will exacerbate the impact of a recession. Households with high debt to income (DTI) ratio are more sensitive towards income shocks and therefore forced to cut back on their consumption. As a result, the economic recovery in the wake of the pandemic is going to be more painful with households holding back on their consumption (Tiftik & Guardia, 2020).

Financial Literacy and Over-indebtedness

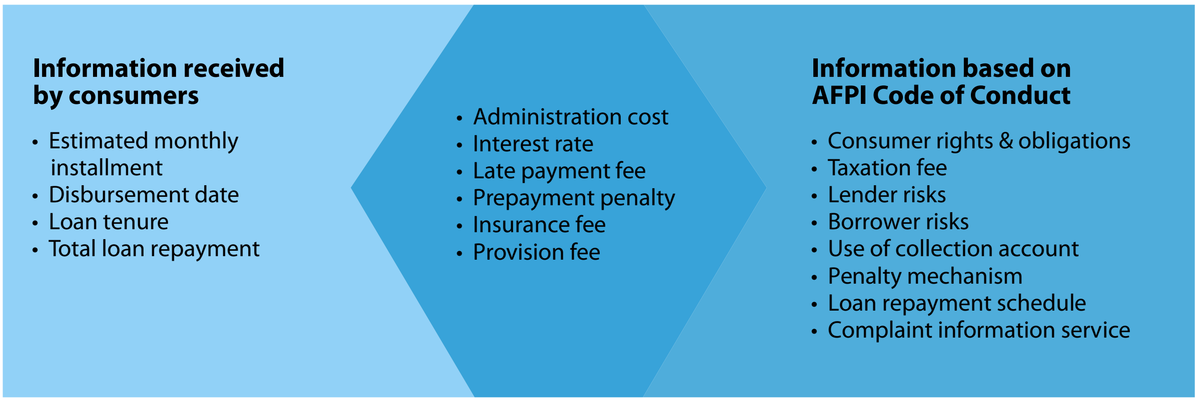
Financial inclusion in the absence of adequate financial literacy possesses a threat of household over-indebtedness. According to the National Financial Literacy Survey (SNLIK) published by OJK in 2019, the financial inclusion index has reached 76,19 percent yet the financial literacy index is at a record low of 38,03 percent. This suggests that broader access to financial services has not been followed by sufficient knowledge and skill to make sound financial decisions. Lack of financial literacy will increase the potential of credit default since illiterate households tend to choose expensive credit and engage in excess borrowing due to inability to calculate their own risks. (Lusardi & Tufano, 2009; Disney & Gatherhood, 2011; Sevim et al., 2012; Anderloni & Vandone, 2010).

Responsibank Indonesia (2019) affirmed that the risk of over-indebtedness is not associated with income and education level, but primarily driven by lack of financial literacy. The mindset of treating credit as an 'extra money' leads to an excessive use of credit for the pursuit of a consumptive lifestyle (overspending). Research conducted by Responsibank shows that credit cards are typically used to purchase lifestyle needs such as holiday, electronic goods, and eating out at fancy restaurants despite the income shocks. Lack of financial literacy can be depicted through the inability of credit card holders to understand the interest rate and costs being charged from using a credit card. This happens clearly as credit card holders often are not careful enough and thoroughly check the credit terms provided by banks. As a consequence, they are not fully aware that minimum payment, overdue payment, and overlimit spending habits will spike credit costs and cause long-term financial issues. Furthermore, the majority of them do not understand the restructuring mechanism if their credit is in arrears or defaults.

Interestingly, aggressive marketing technique is also a major factor that drives over-indebtedness among households. This is typically common among salesforces by selling products that serve their best self-interest without assessing the creditworthiness of future debtors, granting an appropriate limit and considering the number of existing credit cards owned. In some cases, credit cards are even issued without consumer's consent or verification process.

In the case of peer-to-peer lending borrowers, lack of financial literacy can be portrayed through the difficulty of borrowers in distinguishing between legal and illegal platforms. Although in some cases, borrowers voluntarily choose illegal platforms since credit approval from legal platforms takes longer while many others receive loan rejection. Due to urgent circumstances, borrowers were blinded by the extremely high interest typically charged by illegal platforms. Moreover, information asymmetry is another key issue facing illegal P2P lending borrowers due to lack of transparency regarding the interest rate mechanism and fees (Figure 1). The excessive interest rate, service charge, administration fee, and late fee are too burdensome for borrowers to pay. Illegal platforms also purposely trap borrowers into a never-ending cycle of debt by granting an increase in borrower's credit limit. This behaviour promotes an endless cycle of borrowing that will eventually put borrowers into a more severe debt situation.

Figure 1. Information Asymmetry in online peer-to-peer lending



Source: ResponsiBank Indonesia

Over-indebtedness also raises consumer protection issues. Violation against consumer rights includes inappropriate use of data and aggressive debt collection. The ever increasing number of cases suggests that consumer protection is still ignored among financial institutions. The absence of data protection law has put consumers under the risk of data privacy. Furthermore, lack of policy enforcement for regulating cooperation between banks and outsource marketing creates a loophole for data manipulation practice carried out by salesforces in order to achieve targets. Indeed, this cannot be separated from OJK and law enforcer's weak supervisory role in promoting fair and responsible finance.

Many illegal P2P lending engages in unethical debt collection practices and intimidate its borrowers with threats, terrors, and sexual harassment. At worst, the collection practice also involves contacting the borrower's closest circles such as friends, colleagues, and relatives. This immoral debt collection practice significantly affects borrowers' mental health where many of them have at least experienced trauma, stress, depression, anxiety, inability to focus, loss of confidence, as well as social interaction difficulties. In fact, many of them lost their jobs and livelihoods due to abusive debt collection practices. In consequence, over-indebtedness forces them to reduce their allocation for basic needs, health, and education and while others have to sacrifice their assets to pay off debts.

Policy Recommendations

With the great economic challenge of COVID-19 pandemic, over-indebtedness could be a ticking time bomb that is going to exacerbate the recessionary impact of the pandemic. In order to anticipate this, the following are policy recommendation:

- The Central Bank (BI) needs to build an effective monitoring system to improve banking compliance on policies regarding maximum number of credit card ownership and maximum credit limit. More stringent regulation is needed particularly for consumptive credit as it is crucial for mitigating the risk of household over-indebtedness especially during financial stress caused by COVID-19 pandemic.
- Financial Services Authority (OJK) and law enforcement officers need to strengthen regulation, supervision and enforcement of P2P lending business practices. Steps must be taken to strengthen the coordination and the function of Investment Alert Task Force (SWI) to practice laws against irresponsible lending practices performed by both legal and illegal P2P lending companies.
- Credit card issuers and P2P lending companies must proactively educate its consumers regarding risks, benefits and costs of a financial product. Financial institutions and the banking sector need to stop credit card tele-marketing because of its potential in violating consumer rights.
- Credit card issuers and P2P lending companies have to strengthen their credit scoring system by adopting prudent principles which involve assessing borrower's profile, income, credit limit, number of debt commitments and credit history.
- Government needs to build and strengthen the integrated credit database to ensure responsible lending practice that takes into account borrower's credit history and payment capacity to avoid bad credits and defaults.

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