

Consumption Smoothing, Saving, Credit and Insurance

Lecture 8/4: Microfinance

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What is microfinance?

- ▶ Provision of small-scale financial services
- ▶ Still primarily small loans to poor borrowers in poor countries (microcredit)
- ▶ Average loan size \$100-200
- ▶ Some famous names: Grameen Bank (Bangladesh), BRAC (Bangladesh), Accion (Mexico)
- ▶ Key differences from standard banking: small loans, frequent payment, group lending (use borrowers' local presence to overcome information constraints)

Why does it work?

- ▶ Better ability to deal with market failures
- ▶ Local information
- ▶ May lower monitoring and enforcement cost
 - ▶ Peer monitoring
 - ▶ Social pressure
 - ▶ Future access to credit

Group lending/Joint liability

- ▶ Loans are made to groups of borrowers
 - ▶ Usually 5 or so
 - ▶ Usually the borrowers form the groups themselves
 - ▶ No literal collateral
- ▶ Weekly meetings in the village
 - ▶ Very public review of each group's records (passbooks)
- ▶ The entire group is liable for each of its member's repayment
- ▶ If all repay, the group can continue to borrow
- ▶ If one member defaults, all members of the group lose access to credit
- ▶ Incentives for members to monitor each other (project choice, effort, repayment)

Limitations of group lending

- ▶ Best suited to “medium-density” environments, i.e. villages and small towns
 - ▶ Low density makes group monitoring, meeting attendance, etc., expensive
 - ▶ High density reduces the effectiveness of the implicit collateral
- ▶ Tradeoff between monopoly power and credibility of enforcement mechanism
 - ▶ Entry leads to more competition for borrowers
 - ▶ But if I can default with one lender and get a loan from another?
- ▶ Frequent but early repayment
 - ▶ Establish good habits
 - ▶ But costly and can reduce investment

Limitations of group lending

- ▶ Difficult to maintain credibility that all members of the group will be punished
- ▶ Added risk for borrowers
- ▶ Costs of monitoring transferred to borrowers
- ▶ Social sanction may not work very well for enforcement

Microcredit and Adverse selection

- ▶ Villagers form groups themselves
- ▶ They are likely to know better who is relatively risky or safe
- ▶ Villagers will sort into groups with others like themselves, but not all the cases
- ▶ Bank does not need to know which group is which and charge one interest rate
 - ▶ Risky types pay higher effective interest rate because they repay for their partners when the project is successful
 - ▶ Lowers (but does not eliminate) subsidy from safe to risky types
 - ▶ Efficiency gain: lower interest rate keeps safe type from exiting

Microcredit and Adverse selection

- ▶ Assume borrowers know each others' types
- ▶ How will the borrowers match?
 - ▶ A safe type would not want to match with a risky type: when the risky type fails, the safe type will not be able to cover the balance, and both will lose access to future credit
 - ▶ A risky type would prefer to match with a risky type: if his own project fails, then there is at least a chance that his partner's project will succeed and can pay for both of them
- ▶ Positive assortative matching
- ▶ You might see negative matching of Safe with Risky. The safe borrower can always repay the debts of both, and then they could split the upside when the risky type's project is successful.

Microcredit and Adverse selection

- ▶ Participation and enforcement:
- ▶ Why the risky type will follow through on paying when his partner cannot
- ▶ There is an incentive for the successful risky type to break his promise and keep the output
- ▶ Punishment: loses access to credit in the future
- ▶ We'll assume this is a sufficient deterrent
- ▶ Other mechanisms could be social sanction, i.e. being perceived as not trustworthy within the village