



Active risk management and loan contract terms: Evidence from rated microfinance institutions

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ABSTRACT

The aim of this article is to test the relationship among organizational architecture, joint liabilities contracts, and loan conditions. Based on a sample of 135 MFIs rated between 2003 and 2008, the study shows that solidarity lending and a decentralized credit decision have no significant influence on loan conditions. Being a village bank lender is significantly associated with higher interest rates charged, higher outreach, lower depth of outreach, and higher transaction costs. Results seem to highlight the existence of a trade-off between outreach and the average loan size per borrower when MFIs decentralize credit decisions or establish joint liability contracts.

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1. Introduction

Microcredit is no longer an experiment. It has been shown as being one of the most efficient instruments of economic development (Van Maanen, 2005). Through the provision of responsive and specific financial services, microfinance institutions (MFIs) allow the financial inclusion of poor entrepreneurs who, for economic reasons, are excluded from the traditional banking system. Microfinance practitioners¹ recognize that there can be no sustainable performance without sound risk management. The financial literature on risk management considers risk management strategies to be financial decisions, that is, those that create value (Froot, Scharfstein, & Stein, 1993; Froot & Stein, 1998). Risk management therefore becomes one of the major determinants of MFI efficiency and sustainability.

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¹ Anne Gaboury, chairman and CEO of Développement International Desjardins, signed the editorial of the information journal *Finance et Communautés*, in October 2007, stating at the outset that “to manage a business, whatever type of business, one must be able to foresee and overcome a whole range of risks. But when the business is a financial institut[ion], risk management must be a priority, nothing less. . . Operational management, if it is not combined with good risk management, can never lead to a solid and sustainable performance.”

Because capital allocation or lending is one of the core activities of microfinance, MFIs should be able to mitigate information asymmetries that arise from lending. Information asymmetries lead to market imperfection. Microfinance credit market imperfections can be explained by the difficulties that MFIs experience in selecting borrowers (adverse selection) and controlling their behavior (moral hazard) (Stiglitz & Weiss, 1981). MFIs target mainly micro and small enterprises (MSEs) and promoters of income-generating activities (IGA) (Van Maanen, 2005) that are reputed to be informationally opaque. The financial information provided by these MFI clients are neither audited nor certified by accounting firms. Therefore, “hard” information available or disclosed by MFI clients is not sufficient to estimate accurately the likelihood of borrowers defaulting or enable MFIs to exercise direct control over their behavior. Consequently, hard information seems to be less reliable and less relevant. Loan contract terms such as interest rates charged, the amount of the loan, and collateral requirements can contribute to addressing the information problem faced by MFIs. According to Stiglitz and Weiss (1981), these devices lead to credit rationing and encourage MFIs to limit access to credit. Choosing this option seems contradictory with the social mission of microfinance.

The low quality of hard information leads MFIs therefore to set up innovative screening devices in order to reduce agency conflicts between them and their clients and to allow borrowers to

undertake actions that converge with their interests. Those devices rely mainly on “soft” or local information, which is less costly for local moneylenders in microfinance credit market (Stiglitz, 1990). Because of geographical proximity and social and cultural ties, rural populations have an informational advantage over the institution in terms of selection (risk of adverse selection) and monitoring of borrowers (moral hazard). According to Stiglitz (1990), it seems necessary to delegate the credit decision to people who have a better access to this local information. The MFI thus transfers the selection and control of groups of borrowers and delegates the credit decision to the loan officer. Organizational architecture and joint liability contracts appear to be soft lending technologies that can help MFIs to address information asymmetry problems in lending.

The group credit contract, experienced by the Grameen Bank and BancoSol, is considered one of the major innovations in microfinance. Theoretical studies (Armendariz de Aghion, 1999; Armendariz de Aghion & Morduch, 2000; Besley & Coate, 1995; Chowdhury, 2005; Ghatak, 1999, 2000; Stiglitz, 1990) highlight conditions under which joint liability contracts can efficiently mitigate information asymmetries in microfinance lending. Empirical studies investigate the main efficiency drivers of joint liability contracts in groups of borrowers on the one hand (Ahlin & Townsend, 2007; Cassar, Crowley, & Wydick, 2007; Karlan, 2007; Paxton, Graham, & Thraen, 2000; Sharma & Zeller, 1997; Wenner, 1995; Zeller, 1998) and the influence of loan contract terms (interest rate, credit availability) and joint liability contract on portfolio quality, financial, and social efficiency of MFIs on the other hand (Cull, Demirgüç-Kunt, & Morduch, 2007). However, very little attention has been paid to the study of the relationship between joint liability contracts and loan contract terms, namely, interest rates and transaction costs and the average amounts of loans.

Moreover, a strand of banking literature (Berger & Udell, 1995; Berger, Klapper, & Udell, 2001; Degryse & Van Cayseele, 2000; Diamond, 1984; Petersen & Rajan, 1994) and most recently the Behr, Entzian, and Güttler (2011) research in microfinance document that relationship lending helps to overcome information asymmetries and, consequently, influences loan conditions. Another strand of the banking literature in developed countries (Berger & Black, 2011; Berger & Udell, 2002; Berger, Miller, Petersen, Rajan, & Stein, 2005; Brickley, Linck, & Smith, 2003; Stein, 2002) considers the decentralization of the credit decision as an organizational consequence of relationship lending and investigates the determinants of the choice of the decentralization and its effects on the availability of credit. Empirical literature on this issue seems to be scarce and the relationship between organizational architecture and loan contract terms remains largely unexplored in microfinance.

With these considerations in mind, the aim of this article is to study the relationship among organizational architecture, joint liability contracts, and loan contract terms in microfinance organizations. To the best of our knowledge this is the first study answering the question whether setting up joint liability contracts and decentralizing credit decisions lead MFIs to reduce interest rates and transaction costs, thereby offering more loans in number and size. This study goes beyond the literature on the effectiveness of risk management practices in many ways. Unlike Cull et al. (2007), who studied the interaction effect of joint liability contracts and interest rates on MFI financial efficiency, this article focuses on the impact of group-lending contracts on loan conditions. Furthermore, concerning the organizational architecture, we extend Behr et al.'s (2011) research by answering the question whether a decentralized credit decision, or more precisely the association between information production and capital allocation resulting from the relational approach, influences loan conditions.

Moreover, contrary to Behr et al. (2011), who use a dataset of loan applications provided by one MFI in Mozambique, the empirical analysis is based on a sample of 135 microfinance institutions rated between 2003 and 2008. We provide evidence that solidarity lending and credit-decision decentralization have no significant influence on loan conditions. Being a village bank lender is significantly associated with higher transaction costs and higher interest rates charged. Results lead to the conclusion that a trade-off seems to exist between the number and the loan size when MFIs set up joint liability contracts or when credit decisions are decentralized.

The remainder of the article is organized as follows: Section 2 describes the conceptual framework of the research, Section 3 describes the data and the methodology, and Section 4 presents empirical results.

2. Literature

2.1. Credit risk management practices in microfinance institutions

Joint liability contracts are innovative risk management practices used by MFIs (Armendariz de Aghion & Morduch, 2005). Group lending, based on the model of Stiglitz (1990), is theoretically built on the case study of Grameen Bank.² Joint liability contracts put in relation one institution and a pool of borrowers. When the groups formed consist of fewer than 10 people, lending methodology is a solidarity group lending. Loans are granted to individuals, but the group is jointly liable for credit. The collateral is collective. When the group size is between 10 and 30 people, loans are provided through village banks. In this case, the MFI gives credit to the group, which takes charge of the administration of individual loans. The group becomes a relay of the MFI in the lending and collateral for each member. Although joint liability contracts reduce MFIs' lending costs such as information gathering, project monitoring, and borrower auditing (Mahjabeen, 2010), group-lending contracts are not the panacea to information asymmetries. They do not necessarily guarantee a better quality of portfolio (Armendariz de Aghion & Morduch, 2000). Additional mechanisms such as regular repayment schedules or dynamic incentives complement or substitute group-lending schemes (Armendariz de Aghion & Morduch, 2000, 2004; Chowdhury, 2005). Under dynamic incentives, MFIs increase the size of the loans over time only if the borrower honors his or her commitments vis-à-vis the institution. Other instruments (Armendariz de Aghion & Morduch, 2004), such as collateral with a high cultural or sentimental value but a low market value, are mobilized. In Central Africa some MFI loans are secured by inheritances (clothes, watches, necklaces) or by objects with high cultural value, such as leopard skins (for example, the *Mutuelles Communautaires de Croissance* network). Another innovation is savings, which is considered a prerequisite to be qualified for a loan. The provision of nonfinancial services as a complement to credit and saving services also appears as a device that can reinforce relationships with the borrowers and facilitate access to soft information. Godquin (2004) provides evidence that the use of nonfinancial services has a positive impact on microfinance repayment performance.

The choice of a decentralized organizational architecture is a risk management practice that is largely unexplored by the empirical literature in microfinance. Jansson, Rosales, and Westley (2004) recognizes that the activity of microcredit is efficient only if the MFI opts for an organizational structure that delegates most of the credit decisions to the loan officer, particularly if the amount of

² Grameen Bank and BancoSol Bolivia are pioneer institutions of this contract scheme.

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