Asymmetric Finance: Issues in Microfinance

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Abstract. This study surveys microfinance institutions (MFI) which are designed to provide loans and other financial services to the poor, particularly women. Although innovations have reduced loan defaults, most MFIs are losing money. The most profitable MFIs target the upper-end of the poor thereby raising concerns of mission drift. Because profitable MFIs tend to be the largest and most experienced, there is hope that growth over time will lead to self-sufficiency. Increasingly, MFIs are evolving into full-service entities which are raising increasing amounts of commercial funds.

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1. Introduction

1.1. Finance as an Anti-Poverty Tool

In the battle against poverty, from the 1950s to the 1980s, development planning among less developed countries included creating government-sponsored development banks to provide subsidized credit to strategic sectors. The results were highly disappointing as such loans had sorry repayment rates, often below 50 percent, and additional subsidies were often required. For example, Morduch (1999, 1573) reported repayment rates in 51.6 percent in Bangladesh and 30 percent in India's Integrated Rural Development Program. Among the causes of such poor repayment rates for development banks were cronyism and corruption.

Nonetheless, there is evidence that development of financial institutions and markets can reduce poverty in two ways. First, while not conclusively determining causality, studies show that financial development is a good predictor of economic growth. Second, Beck et al (2004) find that financial development also reduces income inequality. In fact the development of financial institutions, because of their expertise in managing problems of asymmetric information, can help provide credit to the small and opaque, that is, the poor.

Financial institutions have traditionally ignored the credit needs of the very poor because of the perceived high default risk. Asymmetric information risks in the forms of adverse selection and moral hazard are especially severe when lending to poor and distant borrowers. The lack of collateral and weak creditor protection compounds the risk. Also, there is little diversification if loans are concentrated in a specific sector such as agriculture. Moreover, high loan rates burden borrowers especially during temporary cash flow problems. In addition, governments sometimes discourage microcredit either by requiring that loans be collateralized or by imposing loan rate caps.

2. Grameen Bank

2.1 The Start of Something Big

Despite this discouraging history, in 1983, in Bangladesh, Muhammad Yunus lent $27 to a group of 42 women basket weavers, all of whom repaid their loans. This initiated the microcredit operations of the Grameen (which means rural or village) Bank and its emphasis on small loans to the very poor. By 2006, it had 6.6 million borrowers and had lent some $5.7 billion (Phillips 2006). The results suggest that repayment rates on micro loans are high, Grameen reports a repayment rate of 98.5 percent, and that microcredit can be profitable. Grameen's success launched a microfinance industry comprised of thousands of microfinance institutions (MFIs) throughout the world.

Grameen's charging of interest and its focus on women borrowers has met resistance from Islamic extremists who have bombed branches of Grameen in Bangladesh and attacked loan officers in India. In addition, Maoists have attacked loan offices in Nepal, and others have murdered the head of the microfinance effort in Afghanistan. Fortunately, such incidents have been rare and, in general, the microfinance movement has been widely lauded as exemplified by the United Nation's naming 2005 as the Year of Microcredit and by the awarding of the Nobel Peace prize to Yunus a year later.

2.2 Innovations in Lending – Joint Liability

Grameen Bank introduced several innovations that reduce credit risk. The best known is the concept of group lending or joint liability. Group lending is a procedure by which a lender makes a loan to an individual belonging to a group of five-to-ten applicants. All group members are then liable to repay the loan in case the individual is unable to do so. In practice, when such defaults occur, lenders do not always demand payment from the other members of the group, but will deny them future credit. Such exclusion provides an incentive for group members to monitor and appropriately pre-select their peers. A downside is that some of these members may themselves be quite creditworthy and so a relaxation of the joint-liability rule is not uncommon.

Group lending significantly reduces adverse selection risk, that is, unknowingly lending to riskier borrowers, because group members would likely be able to better appraise the risk of their peers than could a distant, outside lender. Moreover, the groups are self-selected, suggesting that group membership would be comprised of partners having similar risk and sense of responsibility. Because the riskier groups could be expected to face more loan defaults, their members would face the higher costs of either having to repay on behalf of their defaulting group peers or being denied future credit.