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Competition and microfinance

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Abstract

Competition between microfinance institutions (MFIs) in developing countries has increased dramatically in the last decade. We model the behavior of non-profit lenders, and show that their non-standard, client-maximizing objectives cause them to cross-subsidize within their pool of borrowers. Thus when competition eliminates rents on profitable borrowers, it is likely to yield a new equilibrium in which poor borrowers are worse off. As competition exacerbates asymmetric information problems over borrower indebtedness, the most impatient borrowers begin to obtain multiple loans, creating a negative externality that leads to less favorable equilibrium loan contracts for all borrowers.

JEL classification: O12; O16; L31; L13; L31
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1. Introduction

Since Adam Smith, economists have nearly always favored policies that foster competition, as competition typically results in lower equilibrium prices for consumers. It would be reasonable to expect therefore that an increase in competition between microfinance institutions would unequivocally result in more favorable credit contracts for

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the entrepreneurial poor in developing countries. The purpose of this paper, however, is to show that competition may actually prove detrimental to some or all of the borrowers in a microfinance market.

We develop a model in which a solitary client-maximizing microfinance institution (MFI) competes with an existing informal moneylender to the benefit of each borrower captured in the microfinance portfolio. Subsequently we show three potentially adverse effects of the entrance of *new* MFIs into the same pool of borrowers. First, Bertrand competition between MFIs within the subset of profitable borrowers reduces the ability of a socially motivated lender to generate rents that support lending to the poorest and potentially least-profitable borrowers.[1] This diminution of the capacity to cross-subsidize means that the poorest borrowers in the client-maximizing portfolio are dropped as competition intensifies. Second, we show a number of instances in which failure to restrict grant funding to the poorest potential borrowers can prevent the emergence of a competitive microfinance market altogether, as client-maximizing non-profit institutions undercut profit-maximizers to capture the most profitable borrowers in a given pool.

A third negative effect of MFI competition originates from the likelihood of increasing asymmetric information between lenders. With a greater number of lenders in a market, we would expect information sharing between lenders to become more difficult, all else equal. We show that this creates an incentive for some (impatient) borrowers to take multiple loans. Such instances of multiple contracting both increase average debt levels among borrowers in the portfolio and decrease the expected equilibrium repayment rate on all loan transactions, generating less-favorable Bertrand equilibrium credit contracts. This makes all patient borrowers worse off, and again results in the poorest borrowers being dropped from the loan portfolio. In general, our results show that while wealthier and impatient borrowers are likely to benefit from increasing competition among MFIs, very plausible conditions exist under which an increase in the number of lenders in a market will lower the welfare of the both the poor and the patient.

The widespread enthusiasm for microfinance has spawned a dramatic increase in the number of microfinance institutions in the developing world. Spurred by an accord reached at the Microfinance Summit in 1997 to reach 100 million of the world's poorest households with credit, there is arguably more widespread support for microfinance today than any other single tool for fighting world poverty. The microfinance movement has been both praised and supported by a broad range of academic scholars, major development finance institutions such as the World Bank, and development practitioners themselves. With the number of MFIs involved in this effort now 1600 and growing, the overlap and competition between these institutions are certain to increase.

The rapid early growth of the microfinance movement primarily consisted of non-profit, socially motivated lenders seeking to reach as many poor clients with credit as they were able, given their limited budgets.[2] In the process they demonstrated that through the use of new lending technologies, such as joint liability contracts and dynamic incentives, a substantial portion of this new market could in fact be lent to profitably. This realization has drawn profit-motivated lending institutions into these markets. The presence of

[1] See Shaffer (1996) for an example of cross-subsidization in U.S. lending markets.

[2] Tuckman (1998) provides a good survey of competition among non-profit institutions.