



Designing credit agent incentives to prevent mission drift in pro-poor microfinance institutions

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ABSTRACT

Credit agents in microfinance institutions (MFIs) must be given incentives to acquire information on potential borrowers and select them in accordance with the MFI's objectives. We show that while giving incentives has no cost in for-profit MFIs, it is costly in pro-poor MFIs: When repayment and wealth are positively correlated, a pro-poor MFI cannot obtain the selection of poor clients in the proportion it wishes with incentives based solely on repayment. It then becomes necessary to audit the share of very poor borrowers selected by an agent in order to provide the latter with adequate incentives. When audit costs are large, pro-poor MFIs may have to forego selection on wealth – and use other targeting devices such as working in impoverished geographical locations. Driven by donor concerns with 'mission drift' away from the poor, audits on the wealth status of clients have been introduced at the level of MFIs. We show that introducing pro-poor incentives requires extending such audits to the level of credit agents.

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1. Introduction

Designing optimal incentives for credit agents has become a major concern for microfinance institutions (MFIs). The existing literature on microfinance has focused almost exclusively on incentive issues between borrowers and lenders. Yet, as credit agents play a critical role in ensuring the success of the MFIs they are working for, they must also be provided with adequate incentives. Without those, they may exert insufficient effort to learn about potential borrowers' characteristics, they may under-report repayments, and they may mis-represent the information they have obtained on potential borrowers. The issue is particularly acute in pro-poor MFIs.

Many pro-poor MFIs derive from non-governmental organizations and have non-profit status. Their objective is to give access to credit to very poor individuals with viable projects. There has, however, been a widely noted 'mission drift' among these MFIs as they increasingly tend to work with clients that are less poor, a drift that has accelerated with rising competition from for-profit MFIs (Weiss and Montgomery, 2005). This has led donors supporting these institutions in search for mechanisms that can induce MFIs to resist mission drift. This paper explores how to design credit agent incentives to achieve this result.

If less-poor borrowers reimburse more on average than very poor borrowers, a pro-poor MFI must strike a balance between financial viability and the selection of very poor borrowers. It wants to lend to an optimal mix of very poor and less-poor borrowers selected among individuals with high ability and most likely to repay. The higher expected repayment rate with less-poor borrowers is used to cross-subsidize loans to very poor individuals, while meeting the zero profit constraint. But incentives for credit agents to select high-ability individuals then tend to conflict with incentives to select very poor individuals, who repay less. For these MFIs, repayment is an incomplete measure of an agent's performance.

To induce search for information on simultaneously poverty levels and ability, one would need to use incentive schemes that are non-monotonous in repayment. But such schemes would give the agent incentives to hide, and possibly withhold, repayment. Observing another variable correlated with wealth is thus necessary. This requires costly audits. To meet their objectives, pro-poor MFIs thus have to bear the additional cost of an audit generating signals on the true type of borrowers; by contrast to for-profit MFIs that bear no cost in providing incentives to their credit agents. Audits are, however, not always feasible. In contexts where the cost of finding information on wealth is high, a pro-poor MFI will choose to offer incentives based only on repayment performance, as would a for-profit MFI.

An important assumption in our analysis is that wealth and repayment are positively correlated. If less poor borrowers were not more profitable to the lender than the very poor, there fundamentally would

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be no tension between the outreach objective of the MFI and the viability constraint. There would be no possibility for cross subsidization, and lending to the poor would have to be viable. This would lead to the particular case in which a pro-poor MFI would always lend only to very poor borrowers, and only to very poor borrowers of high ability if acquiring information on ability is not too costly.¹ Yet a positive correlation is more plausible², at least in areas where mission drift is a concern. A positive correlation arises when less poor borrowers have access to better education, better quality inputs and land, and better social capital that facilitate success in their activity. Empirically, *Sharma and Zeller (1997)* in Bangladesh, *SEF (2003)* in South Africa, and *Zeller (1998)* in Madagascar all find that repayment performance does increase with wealth – the very poor tend to invest in low-return activities and in poorly developed markets where environmental and economic shocks are frequent, while they have low ability to bear risk (*Hulme, 2000*). This positive correlation, and the conflict it creates between outreach and financial viability, is confirmed by a concern among practitioners that using repayment performance incentives for agents reinforces their drift towards less poor clients. Based on a global survey of microfinance institutions, *McKim and Hugart (2005)* report that 70% of the MFIs that implemented an incentive scheme acknowledged that it reduced focus on the target population.

Another assumption made is that the agent is risk neutral with unlimited liability. This (admittedly special) case is particularly useful as it offers a clear benchmark: a for-profit MFI would bear no incentive cost due to delegation in this setting. Any cost borne by a pro-poor MFI stems exclusively from the interaction of the particular objective of a non-profit organization with internal incentives. If the agent was protected by limited liability or was risk averse, additional incentive costs would obviously arise but our main insights would hold.

The remainder of the paper is organized as follows. The next section sketches the practical aspects of staff incentives in for-profit and pro-poor MFIs, and then summarizes the related literature. The model is presented in Section 3. Section 4 shows that using an audit procedure is needed to check the poverty level of selected borrowers. Section 5 characterizes the optimal incentive scheme for a pro-poor MFI under asymmetric information and gives examples of current practices used to combat mission drift. Section 6 offers comments on the implications of rising competition on the ability to select very poor borrowers and concludes.

2. Incentives in microfinance in practice and in the literature

2.1. The incentive issue in practice

Most for-profit MFIs have by now introduced incentive wages for their credit agents, with bonuses rewarding high repayment rates. *McKim and Hugart (2005)* surveyed 147 MFIs and report that 72% have formal staff incentive schemes compared to 6% only in 1990 and about 30% in 1999. Among MFIs with such schemes, 83% give individual incentives, not simply branch incentives. These individual incentives consist in bonuses according to the share of the portfolio not at risk, the number of clients, and the value of the outstanding portfolio. Non-governmental organizations more often use the number of clients, and less often the value of the outstanding portfolio, than banks and non-bank financial institutions, probably as a consequence of their different objectives.

¹ Agents would still need to be given incentive to acquire information, rather than selecting borrowers randomly. But the particular difficulties we highlight would not arise.

² *Armendáriz de Aghion and Morduch (2005)* show that this correlation may theoretically be positive or negative depending on the context and the specific clientele of an MFI. A negative correlation can arise when repayment is subject to moral hazard from borrowers, and when poorer borrowers are more willing to reimburse than less poor ones. Since we do not consider moral hazard on the side of borrowers in this paper (the probability of reimbursing is a given characteristic of borrowers), we can safely assume a positive correlation.

Experts in microfinance have observed a systematic evolution among MFIs in moving up the poverty scale away from the very poor in selecting their clients (*Wright and Dondo, 2001; Sustainable Banking for the Poor, 2002*).³ Bi-lateral donors like USAID have shown increasing concern with this ‘mission-drift’, which has led the U.S. Congress to pass in 2000 the Microenterprise Self-reliance Act that mandates that half of all USAID microenterprise funds should benefit the very poor.⁴ One of the main reasons for this drift is that it is easier for credit agents to work with less-poor borrowers: as we argued above, very poor borrowers may not repay as often as the less-poor; they are less educated and require more help from credit agents when preparing and signing loan contracts.⁵ The positive correlation between wealth and repayment plays a central role in this paper.

Selecting the poorest individuals is made difficult by the fact that pro-poor MFIs have few tools to screen borrowers according to their wealth level. To directly screen poor borrowers, pro-poor MFIs mainly use three (imperfect) strategies. One consists in limiting the size of loans; however, non-poor borrowers will still be attracted by these loans when the opportunity cost is borrowing from moneylenders and when larger loans may be expected in the future as part of dynamic incentives to repay (*de Wit, 1998*). They can also take a multiplicity of small loans from different lenders (*McIntosh and Wydick, 2005*). Loan size is thus an inadequate instrument for poverty screening (*Simanowitz, 2004*). A second strategy consists in imposing transactions costs in accessing loans (e.g., frequent repayment installment, required assistance to training sessions) to induce self-selection by the very poor (as theoretically supported by *Besley and Coate, 1992*). However, these costs reduce the poverty reduction value of the loans, and impose additional costs on lenders. A third strategy is to locate branches in areas where most potential borrowers are very poor, or to work exclusively with social categories such as young rural women or indigenous groups where most members are very poor, provided that their repayment rates are sufficient for financial viability. While geographical or demographic targeting serves this purpose, it has limited use for reaching poor borrowers who are not easily identifiable on the basis of observable characteristics. Strategies available to MFIs to directly screen borrowers according to wealth status are thus quite often not effective, indicating the importance of providing agents with adequate incentives to search for that information.

2.2. Related literature

While the literature on micro-credit is extremely large (see, e.g., *Morduch, 1999*), most studies do not consider the internal agency problems of MFIs, although the issue is raised as an important one in *Armendáriz de Aghion and Morduch (2005)*; and only a few studies consider the issue of screening on wealth. This is in strong contrast to the debate among practitioners who insist that giving incentives to agents is both crucial and difficult. The problem of borrower selection has been extensively addressed in the literature with reference to group lending (see in particular *Armendáriz de Aghion and Gollier, 2000; Ghatak, 1999, 2000; Ghatak and Guinnane, 1999; Laffont, 2003*). However, group lending does not solve issues related to selecting borrowers according to their wealth status.

Few papers focus on the incentives of micro-credit agents. As they do not address issues related to pro-poor objectives, we offer a complementary analysis. *Conning (1999)* highlights a specific cost of

³ See also *Amin et al. (2003)*.

⁴ New legislation in 2003 defines ‘very poor’ as people living on less than US\$1 a day or being in the bottom 50% of population below the national poverty line. Accurate and practical poverty assessment indicators that can be used to measure the extent of pro-poor orientation of client MFIs are being actively developed to permit verification that this mandate is being met (*IRIS Center, 2004; Cerise, 2008*).

⁵ Another cause of mission drift is that competition for clients with for-profit MFIs makes it increasingly difficult for non-profit MFIs to use lending to less-poor borrowers in order to cross-subsidize loans to very poor borrowers.

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