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The life-cycle of a microfinance institution: the Irish loan funds

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Abstract

Ireland's loan funds were a long-lived, self-sustaining, large-scale microfinance organization that made millions of loans, without collateral, to the poor. During the first 100 years of their life-cycle, a period of growth ending in the 1840s, they adapted constantly and obtained improvements to their legal structure because they were complementary to the banking system and seen as effective in relieving poverty. In their 2nd century, they became ossified, in part because of competition with commercial banks. The loan funds provide an example of sustainable microfinance under harsh economic conditions and illustrate how organizations change incrementally and, when successful, alter their institutional framework. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

From 1720s to 1950s, a network of non-profit quasi-banks restricted to making small loans to the poor without collateral operated in Ireland. These "loan funds" were primarily intended to serve a poverty relief function by providing credit to the poorest persons in the country. They reached their apex in the mid-19th century, when they were making loans to approximately 20 percent of all households, far more than the commercial banks. The prominence of the loan funds, and their growth and subsequent decline, present a puzzle to development economists, economic historians and others interested in institutional evolution, microcredit, or Irish finance and society. We examine the development of this microfinance institution over its full life cycle, emphasizing not only the lower-tier agency

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problem between borrowers and the fund, but also the more neglected and at least as important, higher-tier problem between fund and depositors. These loan funds illustrate the importance of institutional form to operational outcomes, and can be usefully interpreted using institutional theories, such as those propounded by, for example, North (1984, 1990), and Eggertsson (1990), and theories of economic development and rural organization, such as those found in Hoff et al. (1993). Lin and Nugent (1995) and the essays in Harriss et al. (1995) exemplify the increasing interplay between these two.

The loan fund system offers a very long and rich history with considerable extant documentation and is particularly relevant to modern microfinance, since it allows issues concerning long term sustainability to be explored. [1] Johnson and Rogaly (1997), Buckley (1997), and Morduch (1999, Section 4) argue that sustainability is a central problem in modern microfinance, but one that is difficult to solve in that most modern microfinance institutions have relatively brief histories. Ireland's system is of special interest because it endured in a market where credit arrangements were very difficult owing to extreme macroeconomic instability, including episodes of famine, and a high emigration rate throughout the 19th century. The funds also provide an opportunity to see an example of what can happen to such an institution as an economy shifts from an agricultural to an industrial base; and they shed light on one of the hidden areas of Irish history — the credit arrangements of the Irish poor in the last century. This focus on the Irish system does not imply that it was an ideal model for development: on the contrary, the fund system was sometimes condemned by contemporaries and was not considered especially successful by all observers.

In the next section, we briefly summarize the agency problems that the loan funds had to overcome. We then proceed in Section 3 to explain their growth as a series of responses to these agency problems. As we will see, their early history consists of the accretion of ideas and techniques for solving the market failure in credit for the poor in a newly monetizing economy. In Section 4, we explore the causes of the decline of the system. Throughout these latter sections, and in the conclusion, we discuss the applicability of the theories of institutional development offered by North, Eggertsson, Lin and Nugent, and others.

2. A brief review of the economics of microfinance

Microfinance banks face multiple agency problems; we focus initially on two directly related to intermediation: the higher-tier problem between depositor and bank, and the lower-tier one between bank and borrower. Asymmetric information is at the root of both problems. At the lower-tier the bank does not fully know the characteristics of the borrower or the proposed use of the loan (adverse selection); and it does not know the actions of the borrower once the loan has been obtained (moral hazard). In general, obtaining more

[1] Morduch (1999) is a critical survey of modern microcredit. There is also a new, but rapidly growing literature on historical microfinance. For example, Banerjee et al. (1994), and Guinnane (1994) examine the German credit cooperatives, and Galassi (1996, 1997) examines the Italian system. However, these look at each organization over a period of only a few years, and do not offer the longitudinal insights of the current study. Hollis and Sweetman (1998b) compare several historical European institutions. With the exception of Hollis and Sweetman (1998a), which focuses on the loan funds at their peak rather than tracing out their development and decline, Ireland's loan fund system has attracted little academic interest.