

# Individual lending versus group lending: An evaluation with Kenya's microfinance data

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## Abstract

Group micro-lending has been used successfully in some parts of the world to expand the reach of microcredit programs. However, our study shows that microfinance institutions in Kenya prefer individual lending which is associated with higher default rates compared to group lending. The study also shows that high interest rates increase the odds of client delinquency while loan size is inversely related to delinquency. Given these findings, policymakers need to work for stability in the macro-environment to ensure interest rates charged by microfinance institutions (MFIs) remain stable and affordable. Alternatively, MFIs can develop a graduated scale for charging interest rates in which credit is extended to groups at first to hedge the firm against repayment risk; following this, the firm identifies individuals within the groups whose credit risk has improved and issue progressive individual loans to them. Such individual loans would fetch higher returns in form of interest for MFI and boost their outreach, reduce delinquency, and enhance self-sufficiency.

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## 1. Introduction

The operations of microfinance institutions<sup>1</sup> in Kenya are governed by the Microfinance Act of 2006. According to the Act, microfinance institutions (MFIs hereinafter) are classified into and registered in three different tiers: deposit-taking institutions such as commercial banks, credit-only non-deposit taking institutions, and informal organizations. The latter category includes

rotating savings societies, club pools and financial services associations. The 52 MFIs, registered in Kenya with the objective of facilitating access to financial services among the unbanked poor, currently serve about 6.5 million clients with an outstanding loan portfolio in excess of US\$ 310 million.<sup>2</sup> Despite the enactment of the Microfinance Act in 2006 and the subsequent proliferation of MFIs, available statistics show that 35.2% of Kenyans are still unable to access formal financial services and another 30.2% are entirely excluded from accessing any form of financial service.<sup>3</sup>

Worldwide, the microfinance sub-sector has had to contend with numerous challenges. One of the major challenges faced, especially by personal loan programs of MFIs, is that borrowers are highly risky since they are typically low net-worth individuals with little or no collateral that can be acquired by the MFI in the event of default. A popular remedy to this problem

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<sup>1</sup> Johanna (1999) describes a microfinance institution as a financial institution whose major activities include provision of small loans typically for working capital, informal appraisal of borrowers and investors, provision of collateral substitutes (such as group loans), the provision of social intermediation via group formation, and training in financial literacy and management capabilities. Peer review under responsibility of Africagrowth Institute.



<sup>2</sup> The 52 MFIs are those affiliated to the Association of Microfinance Institutions of Kenya (AMFI), an organization registered in 1999 under the Societies Act to build capacity of the microfinance industry in Kenya. The statistics were accessed February 11, 2013, from the AMFI website: <http://www.amfikenya.com/pages.php?p=1>.

<sup>3</sup> Information accessed December 9, 2012, from Central Bank of Kenya website: <http://www.centralbank.go.ke/financialsystem/microfinance/Introduction.aspx>.

involves requiring borrowers to apply for credit in voluntarily formed groups: since such borrowers know each other, safe borrowers will likely form their own groups, avoiding those with higher risk profiles – this mitigates the adverse selection problem (Armendariz and Morduch, 2007).

The group lending model, first used in Bangladesh, may not be exactly replicable in the Kenyan context: Bangladesh has an area of 147,600 km<sup>2</sup> with 130 million people while Kenya has an area of 580,400 km<sup>2</sup> with 43 million people. This implies that the information network in Kenya could be much weaker than that of Bangladesh where group lending model has operated efficiently; members of a group in Kenya may not be able to as fully monitor how funds borrowed from MFI are used by their peers as members of a Bangladeshi group. Nevertheless, the micro-finance sector in Kenya has largely adopted the Bangladeshi model and runs two broad microcredit programs: personal lending and group lending.<sup>4</sup> Credit is typically granted to finance business/entrepreneurial activities under both programs but it is believed that significant unfulfilled market demand also exists for personal loans to finance consumption and emergency needs (see also Woller, 2002).<sup>5</sup> The two credit programs (personal and group lending) exhibit different characteristics defined by, among others, the rapidity of loan approval, repayment periods (defines as weeks or months), interest rates, and other program specific terms.

Dellien et al. (2005) discusses key differences between the group lending and individual lending programs. First, because time and effort is invested in building social networks that enable groups to select members who are creditworthy under group lending, the role of loan officers is to provide structure, training on loan processes and administrative support. Under individual lending, loan officers bear principle responsibility for loan decisions; they screen, and monitor their clients as well as come up with mechanisms of enforcing repayment. Second, the principle incentives for repayment of group loans is joint liability, group reputation, credit rating and future access to credit for each member, all of which are directly contingent on each member upholding their obligations. On the other hand, individual lending programs use a variety of incentives such as collateral requirements, co-signers and guarantors to promote repayment and repayment discipline is created by strict enforcement of contracts.

Each of the two lending programs has its strengths and weaknesses. Armendariz and Morduch (2000) observe that group meetings facilitate education and training useful for clients with small experience and improve financial performance of their businesses. Other researchers (Godquin, 2004; Madajewicz, 2011) argue that group lending helps mitigate the risks associated with information asymmetry: for instance, because group

borrowers are linked by joint liability, if one of them switches from safe to risky project (moral hazard), the probability that her partner will have to pay the liability rises. This gives group members the incentive to monitor each other. The reduction in group members' default through peer pressure and social ties has also been discussed (Guttman, 2007; Dixon et al., 2007; Al-Azzam et al., 2011). However, Maria (2009) points out that group monitoring may be rendered ineffective where social ties are loose, and the cost of monitoring each other high.

Group lending is not without setbacks. Savita (2007) argues that group lending is associated with additional costs including group formation costs, training borrowers on group procedures, higher degree of supervision and a higher frequency of installment payments. These costs increase interest rates of such microcredit loans leading to enhanced repayment risk. Other researchers argue that joint liability in group lending penalizes good credit risk customers (Giné and Karlan, 2010), could hinder optimal utilization of borrowed funds by clients (Madajewicz, 2003) and might even jeopardize repayment since the incentive of future credit is no longer present in the event that one member fails to pay (Besley and Coate, 1995).

Individual lending programs also present several benefits. For instance, Armendariz and Morduch (2000) find that the guarantor exerts sufficient social pressure on the client to repay MFI loans in Russia and Eastern Europe. However, Laure and Baptiste (2007) argue that the guarantee mechanism, especially personal guarantees, is only meaningful if the borrower has assets that can be pledged as surety, if the institutional framework permits the actual transfer of ownership of the pledge from the borrower to the creditor easily and if the pledged assets are not very liquid. The duo contends that these three conditions are not met in many developing countries. In particular, Kenya has a rigid judicial system with a large number of pending cases which may hinder timely transfer of pledge and most MFI borrowers may not even have "that small collateral". Another benefit of individual lending is that it spares borrowers the negative effects such as time spent in group meetings and loss of privacy when they discuss their financial situation and investment projects with the peers who could oppose such projects (Maria, 2009) in the process impeding their individual growth (Giné and Karlan, 2010).

Given the strong arguments advanced in favor of both individual and group lending, MFIs find it confusing making a choice between the two lending programs. We believe that the choice should be informed, in principle, by each firm's philosophical orientation. The provision of microcredit services has been explained by three philosophical arguments (Armendariz and Morduch, 2000). First is the institutional approach, which argues that institutional sustainability is paramount so that MFIs should be able to cover their operating and financing costs with program revenue. The opposing view is the welfare approach, which argues that MFIs can attain sustainability without achieving financial self-sufficiency.<sup>6</sup> Then there is the middle ground view,

<sup>4</sup> In Kenya, as in Bangladesh, personal lending involves extending credit to an individual borrower while group lending involves extending credit to two or more people who are held liable for each other's credit (Maria, 2009).

<sup>5</sup> In the context of microfinance credit, a business loan is a working capital loan designed to facilitate growth, expansion and upgrade of a business while a personal loan is an unsecured salary advance for customers to meet emergency needs (Faulu Kenya, 2012).

<sup>6</sup> The *institutionalists* argue that large scale outreach to the poor on a long-term basis cannot be guaranteed if MFIs are not financially sustainable while

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