Credit, Microfinance and Empowerment

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Issues

- Credit market failures
- Targeting of microcredit
- Viability of group lending
- Resilience against vulnerability
- Microinsurance
- Trade-offs between outreach and sustainability
- Regulatory frame work

Objectives

- Synthesis of recent evidence to address these issues
- Lessons for investors, donors, governments and MFIs

Credit Market Failures(1/2)

(a) Identification

- Failure occurs when a competitive market fails to achieve efficient allocation of credit
- Costly monitoring, and enforcement and information far from perfect
- Constrained Pareto efficient criterion

- Features
  - Lack of collateral and absence of well –defined property rights
  - Illiteracy, weak communications and costly formal bank arrangements
  - Income fluctuations, and absence of insurance markets compound repayment problems
  - Dependence on agriculture, vulnerability to weather and market shocks, large-scale defaults
  - Segmented credit markets

Credit Market Failures(2/2)

(b) Stylised Facts

- Dependence on informal credit
- Wedge between lending and deposit rates (30-60 percentage points) in informal markets
- Lending rates vary within same credit markets
- Richer people borrow more and pay lower interest rates
- Defaults relatively rare

Innovative Features of Microfinance(1/2)

- Microfinance (microcredit + savings + insurance=microfinance) designed to overcome credit market failures
- Group lending reduces transaction costs and joint liability enhances repayment rates but there are costs
- Progressive lending: small initial loan with sequentially higher loans upon satisfactory repayment
- More than one lender undermines credibility of threats to cut off future loans
- Flexibility in collateral but doesn't help assetless poor
- Targeting of women: more risk averse and higher repayment rates

Innovative Features of Microfinance(2/2)

- Emphasis on savings but is it the best way as a commitment for saving
- Shift from compulsory to voluntary savings
- Regulation and growth of microfinance

Impact(1/4)

(a) Poverty, Vulnerability and Empowerment

- Evidence on poverty reduction mixed but few recent studies offer robust confirmation
- Imai et al. (2010) confirm with Indian data that access to microfinance reduces poverty, using a multidimensional welfare indicator, when loans used productively
- Effects larger in urban areas.
- Imai et al. (2012) show with a cross-country panel that gross loan portfolio of MFIs has a large poverty reducing effect-incidence, depth and severity of poverty.
- Exit from poverty requires longer-term participation.
- Entrepreneurs require time to achieve productive efficiency (Islam, 2011).
- Simulations show that sustained flows to MFIs avoid accentuation of poverty in a slow, faltering recovery of global economy

Impact(2/4)

- Increasing use of randomised control trials (RCTs) but their evidence mixed too
- Banerjee et al. (2009) assess impact of MFI branches in slums of Hyderabad (India) but welfare effects weak
- Karlan and Zinman (2009) assess impact on small businesses in Manila. Benefits accrued mostly to wealthier male entrepreneurs.
- RCT results not generalizable and this methodology not appropriate in macro setting except under special circumstances (natural experiments) (Deaton, 2009, Ravallion, 2005)
- Microfinance loans after the tsunami in Sri Lanka hastened process of recovery (Becchetti and Castriota (2011).
- Households that borrowed from MFIs in Bangladesh better protected against health shocks than non-borrowers
- Also, helped avoid costly adjustment through livestock sale (Islam and Maitra, 2012)
- When gender roles defined by social norms, cooperation and jointness of decision-making more desirable than autonomous control over resources (Ngo and Wahhaj, 2008).
- Women borrowers use health insurance more than non-borrowers with access to insurance through spouses.

Impact(3/4)

(b) Informal Interest Rates

- Greater coverage of MFIs increased moneylender interest rates in villages in which more loans invested in productive activities.
- Presence of local moneylenders beneficial if greater competition between informal and formal lenders enhances access at more competitive interest rates.

Impact(4/4)

(c) Sustainability versus Outreach

- Current emphasis on financial sustainability and dilution of outreach of microfinance
- Presumption: large trade-off
- MFIs providing individual loans more profitable, but fractions of poor borrowers and women lower in those concentrated on group lending (Hermes et al. 2011)
- MFIs' focus on individual wealthier clients characterised as 'mission drift"
- Contributory factors: greater competition among MFIs, commercialisation, change in lending technology, regulatory measures (Cull et al. 2007, 2011, Conning and Morduch, 2011)
- Sustainability feasible without mission drift by reducing costs and greater efficiency through ICT
- Supervision negatively related to outreach and with percentage of women borrowers
- Positive relationship between subsidy and efficiency of MFIs but up to a threshold
- Social networks help diffusion of microfinance and lower transaction costs

Lessons(1/3)

- MFIs reduce poverty, vulnerability to health risks and hasten recovery after natural disasters
- Exit from poverty requires longer- term participation.
- Small entrepreneurs require time to achieve productive efficiency.
- Larger loans sooner rather than later but without diluting the focus on poor desirable.
- If gender roles defined by social norms, investment in joint productive activity enhances woman's bargaining power.
- So jointness of decision-making is more important than autonomous control over resources.
- Case for more flexible lending technology.

Lessons(2/3)

- Loan contracts with frequent repayment discourage investments with longer gestation period.
- Group lending solves dual problem of missing collateral and intermediary capital.
- Switch to individual contracts as group lending causes excessive peer pressure, transaction costs and unsatisfactory in heterogeneous groups.
- Excessive competition and overborrowing through multiple loans blamed for microfinance crises in several developing countries
- Credit bureaus with unique identification part of a solution
- Trade-off between financial sustainability and outreach.

Lessons(3/3)

- Trade-off large for small loans
- Little leverage from commercial capital markets in poorest communities
- Non-profit charter may help attract outside capital and prevent mission drift
- Use of existing social networks reduces transaction costs and expands outreach to poor without diluting financial sustainability

Conclusion

- Erosion of magic of microfinance avoidable