Strength in Numbers?

Group lending, traditionally believed to promote group solidarity with peer pressure as a disincentive against default by individual borrowers, actually has the opposite effect, Karlan reveals. Photo Credit: Procsilas

In the last 15 years, the group lending model has arguably become the most important tool to make credit available to people who lack access to the formal financial markets. However, despite obvious advantages like improving repayment rates, it can sometimes create tension within communities and discourage some clients from borrowing. A study conducted in the Philippines by Dean Karlan of Yale University and Xavier Gine of the World Bank found that converting borrowers from group to individual liability did not decrease repayment, and expanded the bank's client base. In this Commentary, Karlan reinforces the need to test underlying assumptions in microfinance in order to develop products that are best suited to the targeted communities.

Group liability is commonly thought of as the key innovation that sparked the explosion of the microcredit movement, starting with Grameen Bank in the 1970s. Prior to this, access to credit was severely limited among the poor, in part due to information asymmetries that discouraged lenders from extending credit to households without collateral. Group liability attempts to address this problem by making loans to individual borrowers dependent on group repayment, replacing traditional collateral with peer pressure as a disincentive to default.

Assumptions Surrounding Group Lending

But, is group liability really the silver bullet for the challenges of providing credit to the poor? Despite its widespread popularity, assumptions about the value of group liability have not been carefully verified in practice. In fact, there is evidence that group liability has significant downsides. At Innovations for Poverty Action (IPA), we have heard arguments that it creates tension within communities when members face difficulties in repaying. Furthermore, because group liability requires taking on responsibility for others in order to access a loan, it may also discourage good clients from borrowing and decrease the size of the client base, jeopardizing both the sustainability and growth of microcredit programs.

In theory, group liability can improve loan repayment through several channels. Making a group of clients liable for each member's loans allows the lender to use local information by incentivizing mutual screening, monitoring and enforcement. Clients have an incentive to keep overly risky borrowers out and allow only trustworthy individuals into the program. Once a group is formed, clients are motivated to keep an eye on one another, making sure that funds are invested in profitable enterprises. Finally, enforcement is enhanced because clients face peer pressure to repay their loans.

Group liability requires taking on responsibility for others in order to access a loan, it may also discourage good clients from borrowing and decrease the size of the client base, jeopardizing both the sustainability and growth of microcredit programs.

The theory of group liability also identifies pitfalls that are evident in practice. First, tension between group members over repayment may break down social capital and safety nets within communities. Second, bad clients can "free ride" off of good clients – choosing not to repay because they believe others will do so for them. Third, group liability is costly for responsible clients who may be required to repay the loans of their peers, making it difficult to attract and retain the best clients. Finally, clients with smaller loans may be reluctant to serve as a guarantor for those with larger loans. Thus, while repayment may or may not improve under group liability, conflict within groups may break down group ties and social capital, reduce the existing client base and make it difficult to attract new clients.

The Shift to Individual Lending

In recent years, many institutions have made the shift to individual liability while still keeping the "group" intact for administrative purposes. For example, BancoSol in Bolivia has converted large shares of their group liability portfolio into individual liability lending, and Grameen Bank in Bangladesh has recently relaxed the group liability clause in the Grameen II program. This approach appears to preserve many of the benefits of group lending without the unintended costs of group liability. Organizing borrowers in groups lowers transaction costs by simplifying loan disbursal and collection logistics, and may maintain some of the monitoring and enforcement effect due to the shame of defaulting in front of an audience of peers. But until recently, there has been little quantitative evidence to support lenders who take this approach.

> Attracting and retaining clients should also be a first-order concern for lenders, both those with a profit-imperative and those with a social mission.

What do Randomized Experiments Reveal?

In search of robust evidence on how the theory of group liability plays out in practice, IPA partnered with Green Bank of Caraga in the Philippines to conduct two randomized experiments measuring the effect of group versus individual liability. In the first experiment, IPA worked with approximately 170 existing groups of 20 borrowers, and randomly chose half to be converted to an individual liability contract. By holding all other factors constant – including weekly group meetings to collect loan payments – we were able to isolate the effect of the liability arrangement on default rates and other important outcomes.

We found that converting existing borrowers to individual liability did not decrease repayment rates, and in fact, expanded the bank's client base by attracting new borrowers. Loan centers that allowed individual liability to replace group liability saw higher client growth, due to fewer dropouts and intake of new clients. Clients in these centers were, as expected, less likely to monitor each other's loan performance, but this did not lead to higher default rates.

Because the Green Bank experiment involved transitioning existing borrower groups, the results only reflect the impact of group liability on monitoring and enforcement, not on screening potential clients. Although new clients did enter after the transition, the original groups were peer-screened and selected under group liability. While removing incentives for peer monitoring and enforcement did not reduce repayment, the initial selection process may still have had a significant effect.

> The potential downsides of group lending have been under-scrutinized, perhaps because low default rates may be mistaken for overall success in microfinance.

So in a second experiment with Green Bank, IPA tested what happens when groups are initially formed under individual liability. Under this product design, individual liability still did not cause any decrease in repayment rates, although it did cause bank staff to form fewer new groups, citing concerns about the lack of a local guarantor for loans.

The experience of Green Bank in the Philippines – as well as a number of other institutions – suggests that the assumptions underlying group liability's popularity should be examined more closely. The potential downsides have been under-scrutinized, perhaps because low default rates may be mistaken for overall success in microfinance. Unfortunately, low default doesn't necessarily indicate a positive effect on intended beneficiaries among the poor. Furthermore, attracting and retaining clients should also be a first-order concern for lenders, both those with a profit-imperative and those with a social mission.

Conclusion

The choice of individual or group liability is one of the most basic decisions lenders make in designing loan products for the poor. Could some better serve both their social and financial interests through individual liability? The mixed theoretical and empirical evidence on this question underlines the importance of further field research. It may be that group liability is well-suited to certain lenders or types of borrowers – poorer or newer ones, for instance – but not to others. Replicating robust field experiments in different countries, with different lenders, under different types of contracts will lead to a deeper understanding of when the benefits of group liability outweigh the costs. ■

References

Ghatak, M. and Guinnane, T. "The Economics of Lending with Joint Liability: A Review of Theory and Practice." Journal of Development Economics 60 (October 1999).

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Dean Karlan is a Professor of Economics at Yale University. His research focuses on social policies in developing countries, which often means examining microfinance programs. He is the President and Founder of Innovations for Poverty Action (IPA), a non-profit organization that applies rigorous research techniques to solving real-world problems faced by the poor. It creates and evaluates approaches to solving development problems. Using research results to identify effective interventions, IPA disseminates information to policymakers, practicioners, investors and donors around the world.

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