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Recent Advances in Lending to the Poor with Asymmetric Information

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Abstract

Microfinance institutions have successfully extended unsecured small loans to poor and opaque borrowers at the bottom of the economic pyramid. This success is largely due to innovative financial contracts that impose joint liability and create dynamic incentives to mitigate the effects of asymmetric information. Given recent advances in microfinance contracts, there is a need to map the theoretical developments. This article aims to accomplish that by performing a critical literature survey of microlending contracts, focussing on joint liability and dynamic incentives, bringing out some of the deficiencies of contract-theoretic propositions that cannot effectively account for the social mission of microfinance.

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Notes

1. Nonetheless, Karlan and Zinman (2008) show that rate sensitivity increases at higher rates, for example the levels of loan take-up were up to six times greater for interest rate levels higher than the lender's standard rate.

2. Many issues of the microfinance industry are discussed at an introductory level by Armendáriz and Morduch (2005), which to our knowledge is the only textbook on microfinance to date.

3. Hermes and Lensink (2007) provide a survey of empirical evidence. Their paper can be seen as complementary to our work that focuses on the underlying theoretical developments.

4. Given $Y^L > \rho$ and the zero-profit condition, the safe types always repay, so they would be charged $r_s = \rho$. The risky types allow the MFI to break even if $r_r = [\rho + (1-q) v]/p_r$.

5. Following Stiglitz (1980), the choice of actions or behaviour can be viewed as a choice of projects. Tirole (2006), Section 4.6, follows this approach.

6. Chowdhury (2010) shows that microlending contracts à la Grameen (with features like joint liability lending, sequential lending, contingent renewal, and so forth) can harness market efficiency in places where formal and conventional contracts may fail.

7. In Laffont and Rey (2003), while MFIs do not benefit directly from borrowers' collusion, information-sharing among microentrepreneurs is better for repayment, even if the entrepreneurs collude. The first best is achievable if borrowers share information about each other's efforts and do not collude.

8. In the extreme case of continuous repayment, lenders receive signals about the borrower's progress at every moment in time.

9. See Petersen (2004) for a conceptual discussion of soft vs. hard information.

10. In Chowdhury (2005) in case of successful repayment by both borrowers the group's total payoff is shared by the two borrowers. One gets share α and the other gets $1-\alpha$. Our presentation corresponds to $\alpha = 1/(1+\rho)$. In any case, results of Chowdhury (2005) are robust with respect to α.

11. Notice that our review has a different focus to that of Hermes and Lensink (2007).

12. Consider, for example, a group of two, where each member shirks thinking that the other one will repay. In this case, the chances of group default rise.

13. Theoretical models accept that group members do not share the same monitoring ability as in Bond and Rai (2008). Weaker borrowers have a higher willingness to repay, since they are threatened with tougher sanctions ex post. Even when both borrower types have viable investment opportunities, co-signed loans are preferred to group loans if the power relation within the group is sufficiently unequal.

14. Research into pro-social mission versus preference for financial sustainability of MFIs has led to new literature on potential mission drift. Much of this literature is empirical and does not directly relate to microlending contracts, therefore, covering it extensively is beyond our scope. Nonetheless, it has governance implications for MFIs and we discuss it briefly at the end of the paper.

15. See Microsharks. Rapid expansion of Indian microcredit leads to a turf war with the government in The Economist, 17 August 2006.

16. Karlan and Morduch (2009) provide an excellent survey of issues related to the socio-economic impact expected of microfinance.

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Microfinance Meets the Market

Source: The Journal of Economic Perspectives

Group lending, local information and peer selection

Source: Journal of Development Economics

Moral hazard and peer monitoring in a laboratory microfinance experiment

Source: Journal of Economic Behavior & Organization