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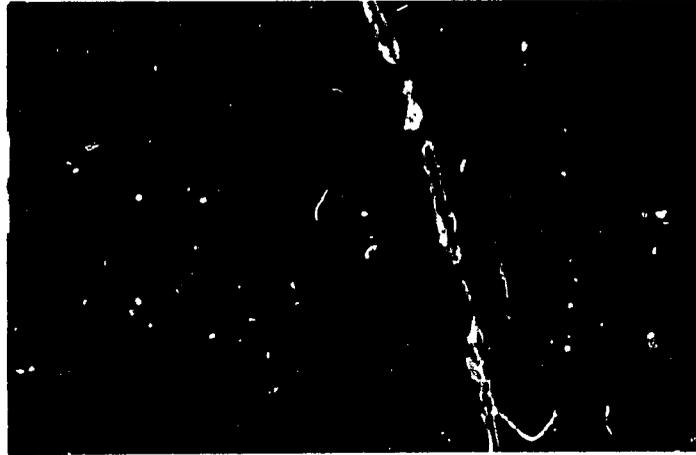
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LENDING TO RURAL POOR THROUGH INFORMAL GROUPS: A PROMISING FINANCIAL MARKET INNOVATION?

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Recently, many low income countries (LICs) have attempted to increase formal loans going to agriculture in general and to the rural poor in particular. Most have been successful in expanding agricultural loans, but few have made much progress in reaching the rural poor. Public as well as private financial institutions have resisted lending to the rural poor because small loans are relatively expensive to administer, many potential borrowers of small amounts have unsatisfactory loan collateral, and interest rate restrictions severely limit the revenue which lenders get from small loans. To overcome these problems, LICs have experimented with various financial market innovations in order to more efficiently serve the rural poor. These include special central bank rediscount facilities, loan guarantees, tax concessions, concessionary reserve requirements, highly specialized new lending institutions, credit cooperatives, supervised credit programs, and nationalized banks.

Recently, some LICs have experimented with still another financial market innovation, group lending.¹ In a few cases like Bolivia, Ghana, Mexico, the Philippines, Thailand and Turkey a substantial portion of loans to small farmers is made through these groups. In other cases such as Bangladesh, the Dominican Republic, Malawi, Nepal, Lesotho, Ivory Coast, and Sri Lanka group lending is done on a regional or pilot project basis. Typically, groups are small--5 to 30 members--and seldom have legal status. Groups usually receive nonsecured loans which are then distributed to members who have joint liability for repayment. If technical assistance accompanies the loan, it is given to the group rather than to individuals.

At least five advantages are claimed for group lending. For the lender: (1) default risks are reduced because of joint liability; (2) loan transaction costs per unit of money lent are reduced by making one sizable loan rather than a number of small individual loans; (3) technical services can be introduced more cheaply than if they were provided to individuals; and (4) scarce manpower can be spread more thinly than if individual loans were made, and thus provide institutional credit to rural poor who otherwise would be excluded. Moreover, small borrowers (5) should benefit because borrower transaction costs for group loans should be less, per unit of money borrowed, than for individual loans.

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Despite the growing importance of group lending in LICs, only a small amount of research has been done on the subject. This paper summarizes the findings of the few studies done on the various advantages claimed. We end up by drawing a few tentative conclusions for policymakers.

Joint Liability

The joint liability of a group loan is attractive to lenders. In theory, it offers the lender more loan repayment security at a lower cost than typically is available from individual small loans. In many LICs it is virtually impossible, for political as well as legal reasons, for lenders to foreclose on land mortgaged by small farmers. Ideally, through groups, peer pressure may be invoked to force recalcitrant borrowers to repay. Thus lender costs of collecting overdue loans are reduced because the group acts as a collecting agent.

Experience shows that joint liability yields mainly negative results. In the Philippines, where groups were hastily formed and members felt little or no obligation to each other, joint liability has been a mirage.² If several members fail to repay, other members may refuse to pay the defaulting members' shares, and also decide to default on their own loans. As a result, the entire group defaults and disbands. More typically, as in the cases of Bolivia and Ghana, the lender does not enforce joint liability. If several members of the group do not repay their share of the loan, the lender absorbs the loss, the defaulters are dismissed from the group, and a new loan is granted to the reconstituted group.³

Peer pressure appears to have been effective in improving repayment performance in only relatively few cases. A group lending program in Malawi, for example, has experienced relatively high repayment rates. This is due, in part, to a required deposit of 10 percent of the total value of the group loan which must be deposited in cash with the lender at the time the loan is made.⁴ The deposit is placed in a blocked interest-bearing account which is unblocked once the loan is repaid in full. If the loan is partially repaid, the deposit is used to cover shortfalls. Nepal has a similar scheme; the Agricultural Development Bank withholds 5 percent of the value of loans made to groups. If a group repays its loan in full, the 5 percent forced savings is turned over to the group for its uses. In some countries, village or group leaders are responsible for loan recovery. This appears to work well where village organizations are strong or where the informal group derives substantial "organization good" in addition to access to formal credit.⁵ Where the sole reason for forming the group is to get a loan, the additional good may be nil. The forced savings features of some group lending programs may help to provide part of this noncredit organizational good.

The information available from several countries on repayment performance strongly suggests that the quality of loan services provided to the group by lenders is closely associated with the willingness of borrowers to repay. If the borrower views the lending program as temporary, if loans arrive late, if the lender's technical assistance is close to worthless, and if

the lender does not provide emergency credit to borrowers, group members may lose little by not maintaining a good credit rating. Borrowers who damage their credit rating by defaulting on loans from lenders providing high quality financial services lose something substantial.

Lender Transaction Costs

Lenders incur two types of loan transaction costs in making loans to the rural poor. The first is the direct costs of making, administering, and collecting the loans. These direct costs of lending, per unit of money lent, vary inversely with the size of the loan. Other things being equal, small individual loans should be more expensive per unit of money lent than would a larger loan made to a group. The second type of cost is made up by supervision or technical assistance provided the borrower by the lender. In a few countries, such as Bolivia and the Philippines, these technical services are provided by a national extension service, and society at large absorbs these transaction costs. In most countries the group lending agencies must absorb these technical service costs: e.g., Bangladesh, Dominican Republic, Nepal and Sri Lanka.

Group lending agencies may also incur a third type of cost, that of forming groups. In the Dominican Republic the Dominican Development Foundation (DDF) bears the entire cost of forming its groups.⁶ Their groups must function 3-12 months before a group loan is granted. Meanwhile, DDF promotion agents work intensively with the group to develop group objectives, cohesion, and to weed out weak members. Group formation costs are a very large item in the overall budget of DDF.

In Turkey and Nepal group formation costs are very small because loans are made through existing village organizations or traditional informal groups. In Thailand and Ecuador organizations responsible for forming cooperatives bear most of the costs of setting up pre-cooperatives which receive group loans from formal credit sources. In Bolivia and the Philippines very little time or effort has been spent in forming groups. In some cases a few small farmers who were standing in line to negotiate individual loans with the lenders were joined on paper and received a group loan.

Efficiency of Providing Technical Services

Little information is available on the costs of providing technical assistance to individual or groups of small farmers. As indicated previously, in those countries where the national extension service is responsible for providing assistance to groups, the amount of service extended is minimal; weak extension services cannot be expected to work miracles. Groups involved in regional or pilot projects receive more intensive supervision. In the Mexican Puebla project groups may be visited almost weekly by project technicians.⁷ Similar intensive supervision and training occurs in Bangladesh, Malawi and the Dominican Republic.

In most cases where technical assistance is effective, an agency apart from the lender provides subsidies to fund most of the costs; in the Dominican Republic, DDF has received grants from various sources over the years and in the Puebla project the Rockefeller Foundation has funded a number of project costs. In one Bangladesh project technical assistance is provided by a university.⁸ Evidence suggests that group technical assistance works best when groups produce a single commodity, group members have homogeneous characteristics, and groups hold well-attended regular meetings at which significant business is transacted.

Spread Scarce Manpower

The experience of countries where group lending is extensive and also countries with mainly regional and pilot group lending projects, shows that new borrowers can be reached through group lending. In Ghana, for example, in 1976 the Agricultural Development Bank made loans to 3,403 groups with a total of 74,278 members. In the Dominican Republic DDF served 4,668 borrowers through 212 groups in 1977-1978. The limited manpower of these institutions would not have enabled them to service these small borrowers on an individual basis. Similar comments can be made about group lending activities in Bolivia, the Philippines and Thailand.

Although group lending activities allow serving a larger number of small borrowers, the key question is whether these limited technicians can recover a substantial portion of the larger loan volume. In the Philippines, repayment rates by groups have deteriorated steadily since 1973 when group lending was initiated, and has forced lenders to sharply reduce group loans. There has also been a reduction in the number of borrowers through groups in the Dominican Republic and Bolivia. Spreading a staff too thinly and including large numbers of untested new borrowers in the program can seriously affect repayment performance and sharply increase loan collection costs.

Borrower's Loan Transaction Costs

Typically, a borrower must visit the lender's office 2-3 times to apply and negotiate a loan, another 2-3 times to receive several releases of the loan and at least one visit to repay the loan. The borrower's costs of productive time lost, the transportation, commissions, lawyer's fees and even bribes can be substantial. These transaction costs often exceed the interest charges paid by new small borrowers.

Consistently, across countries, group lending appears to reduce borrower's loan transaction costs.⁹ Typically, borrowing costs for a group are kept low because only several designated group leaders spend time negotiating the loan. In Bolivia studies show group members have substantially less cash outlay and less time lost in getting a loan, than do farmers receiving individual loans. In the Dominican Republic and Bolivia, members of groups take informal collections

to cover out-of-pocket expenses for leaders who negotiate the loan. In other cases the group leadership is rotated periodically so that costs of negotiating the loans are shared among various members of the group. In Turkey these costs are minimal since bank officials visit the village to negotiate the loans.

Most groups require members to attend periodic meetings to remain eligible for group participation. In the Dominican Republic and in Thailand members are forced to attend a large number of meetings before receiving loans. Unless members benefit from meetings, because of information or organizational goods they receive, they may interpret these meetings as simply additional loan transaction costs.

It is clear that farmers are generally leery of joining groups because they lose some degree of personal freedom, and if joint liability is enforced, they may be forced to cover someone else's debt. Even worse, the individual may lose a good credit rating if the group does not repay its loan. Ceteris paribus, almost all borrowers would rather receive an individual loan. Despite these reservations, it appears that participants view lower transaction costs as strong incentives to seek loans through groups. Only in the Philippines do borrowers complain about their loan transaction costs being essentially equal for group loans and individual loans.

Potential for Group Lending

The ultimate usefulness of group lending will be determined by how it affects the overall costs of financial intermediation, and how these costs are shared among borrowers and lenders. If it is a useful innovation, it will reduce overall costs and also not increase the costs of any participant.¹⁰ If the borrower's costs are reduced, he or she will be more eager to participate in financial intermediation. If the lender's costs are reduced, he or she will be willing to increase the amount and quality of financial services provided to the rural poor.

Too little research has been done on group lending to arrive at final conclusions about its potential. The fragmented evidence which is available, however, suggests it is no panacea; some group lending programs have performed poorly, while others have yielded satisfactory results. A few common elements do emerge, however. On the negative side, it appears that joint liability alone is not effective in improving repayment. Peer pressure works only where there is strong group solidarity, and relatively few groups have this. High loan repayment rates appear to be closely associated with high quality loan services. If these services, plus the other benefits derived from group membership, are sufficiently valuable to borrowers, they will repay their loans. Borrowers contrast the value of a good credit rating, continued access to loans, and other benefits of group participation with a once and for all income transfer through default.

On the positive side, most group lending programs substantially reduce borrower's loan transaction costs. It is not clear, however, whether the joint costs of both borrower and lender are reduced. In a number of cases the lender absorbs some transaction costs formerly incurred by borrowers under individual loans. In addition, the lender may be forced to spend a good deal of money to help form the group, and also to provide technical assistance, unless public funds are used for this purpose. The lender may face a Hobson's Choice of spending more on group formation and technical assistance, or spending more trying to collect bad debts from defunct groups. In either case, the lender's loan transaction costs for group loans are likely to be higher than for individual loans. If this turns out to be generally true, group lending will have little long run impact on expanding loans for the rural poor. It is becoming increasingly clear that rural poor make relatively little use of formal financial services because of supply-side considerations rather than demand limitations.¹¹

The limited success with group lending raises general questions about financial innovations. Clearly, some innovations fail because they do not reduce costs of financial intermediation. Others, however, reduce these costs, but also fail. Why? Some tentative answers to this question might be drawn from the recent experience with new high yielding seed varieties. These varieties were successful because they dramatically lowered production costs. But, equally important were the prices of the products. Would the miracle wheat varieties have been so highly successful if most governments had insisted on maintaining wheat prices substantially below equilibrium prices? We think not. The ubiquitous concessionary interest rate policies applied to small farmer loans in most low income countries seriously limit the net returns from any financial innovation like group lending. No lender can long survive when it receives 10 percent on a loan which costs the agency 25 to 30 percent. Even the most highly productive innovation cannot overcome these kinds of price-cost differentials. We feel that more realistic and flexible interest rate policies would provide a more healthy economic and political environment for financial innovations like group lending.

NOTES

1. In most countries this is a new experiment, but at least two countries, Japan and Turkey, have used group loans to reach small farmers for over 75 years.
2. Rodolfo M. Matienzo, "Repayment and Group Lending in the Province of Camarines Sur, Philippines," Unpublished Ph. D. dissertation, The Ohio State University, 1978.
3. Kwame Opoku-Owusu and William Tetteh, "Small Farmer Group Lending Programme (1969-1976)," Unpublished paper, Agricultural Development Bank of Ghana, Accra, Ghana, June 15, 1977.
4. M.C. Alexander and P.J. Scott, "The Implications of Group Credit for Rural Development in Malawi," Unpublished paper presented at Eastern Africa Agricultural Economics Society, Lusaka Conference, May 1974.
5. See Mancur Olson, The Logic of Collective Action, Cambridge: Harvard University Press, 1971.
6. Alfredo Pablc, "An Analysis of Group Lending Activities in the Bonao Area of the Dominican Republic," Unpublished M.S. thesis, The Ohio State University, 1979.
7. Heliodoro Diaz-Cisneros, "Credit Among Small Farmers: The Case of the Puebla Project of Mexico," Small Farmer Credit in Mexico and Central America, Vol. 1, A.I.D. Spring Review of Small Farmer Credit, Agency for International Development, Washington, D. C., February 1973.
8. Muhammed Yunus, "Bhumihun Samiti (Landless Association) and Mohila Samiti (Women Association) in Jobra and Other Villages," Unpublished paper, Department of Economics, Chittagong University, Bangladesh, October 1978.
9. D. W Adams and G.I. Nehman, "Borrowing Costs for Agricultural Loans in Low-Income Countries," Journal of Development Studies, January, 1979.
10. Some financial market innovations are cost increasing. These innovations are often aimed at evading the intent of regulations.
11. For example see, Claudio Gonzalez-Vega, "Interest Rate Restrictions and Income Distribution," American Journal of Agricultural Economics, Vol. 59, No. 5, December 1977, pp. 973-976.