Policy brief
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International
Growth Centre

Intermediated Loans

A New Approach to Microfinance

In brief

- Microfinance attempts to be an effective tool for increasing financial inclusion for the world's poor. However, microfinance programmes often prescribe rigid repayment schedules and a lack of tolerance for risk-taking. Thus, growth and poverty reduction impacts have been limited.

- This study asks whether it is possible to design a more flexible system of microfinance that targets smallholder agriculture but does not require collateral nor endanger financial sustainability. This system would drop savings requirements, have less rigid repayment schedules and reduce/eliminate costly meetings with MFI officials.

- The authors design and implement an agent-intermediated individual liability loan (AIL) system in a field experiment. A group-based lending (GBL) exists as a control.

- **Key results:**
  - Traders appear to work better compared to agents recommended by local government, and better than GBL in terms of takeup and repayment.
  - Policy makers should use existing economic links within the community. Economic links appear to work better than social and political networks.
  - There is no one size fits all policy. GBL and AIL can be offered at the same time; the poorest selecting GBL, with small and marginal landowners adopting AIL.

- **Recommendations:**
  - Harness local information and social capital when appointing loan intermediaries.
  - The selection process of an intermediary agent differs depending on whether they are traders or those recommended by local government. The former have mainly economic links with potential borrowers; the latter have social and political links.

Policy Motivation

"Growth and poverty reduction impacts have been limited, as microfinance has not succeeded in financing agriculture owing to the rigid repayment schedules and lack of tolerance for risk-taking"

Over the last two decades microfinance has been viewed as a panacea for all ills faced by credit markets in developing countries around the world. However despite the rapid growth in outreach, financial inclusion is far from universal and a large proportion of the world's poor are effectively excluded from the credit market. Growth and poverty reduction impacts have been limited, as microfinance has not succeeded in financing agriculture owing to the rigid repayment schedules and lack of tolerance for risk-taking. Additional screening mechanisms used by MFIs include savings requirements and attendance in weekly meetings by clients, which impose high costs on the latter. Individual liability loans on the other hand rely on collateral requirements to ensure high repayment rates, which reduce access for the poor.

The main question addressed in this project is whether it is possible to design a more flexible system of microfinance that targets smallholder agriculture, without requiring collateral and without endangering financial sustainability. This system should allow individual liability loans without requiring collateral, drop savings requirements, have less rigid repayment schedules (so that recipients can invest in high return projects with longer gestation period like agriculture) and reduce/eliminate costly meetings with MFI officials. The key idea is to appoint local agents as loan intermediaries, who are incentivized to select safe borrowers and enforce high repayment rates. Dynamic incentives for repayment for borrowers are created by linking access to future credit on repayment of current loans.

We design and implement an agent-intermediated individual liability loan (AIL) system in a field experiment, with group-based lending (GBL) as a control. We compare targeting (selection), takeup, repayment rates and impacts on borrowers. We build a theoretical model that addresses some of these issues relating to incentives and use the model to interpret the results. Relative impacts on borrower cultivation, incomes and assets is deferred to subsequent papers since the experiment is still ongoing.

"How to appoint the loan intermediary agent is an important question, since the selection process is likely to be very different depending on who the agent is"

From a policy perspective the AIL approach resembles the recent policy recommendation by the Reserve Bank of India to set up a network of banking correspondents (BCs) and banking facilitators (BFs) in order to expand financial services to rural areas, remote locations and uncovered households. How to appoint the loan intermediary agent is an important question, since the selection process is likely to be very different depending on who the agent is. Policy makers are concerned about the power and influence these agents or intermediaries are likely to wield and the consequences of the abuse of such power. In our experiment we consider two categories of potential agents: traders (TRAIL), and those recommended by the local government or village council/gram panchayat (GRAIL). The two types of agents have very different kinds of links with potential borrowers: the former mainly economic links, while the latter have social and political links.

Policy Impact

This research will contribute towards designing a more flexible system of microfinance that targets smallholder agriculture, without requiring collateral and without endangering financial sustainability. In doing so, it will seek to provide access to credit to the vast number of financially excluded poor which finances agriculture, thus enabling a higher impact on growth and poverty reduction.

"Policy makers should use the existing economic links within the community. Economic links appear to work better than social and political networks"

Key Audience

Policy Makers and MFI officials.

Policy Implications

- TRAIL appears to work better compared to both GRAIL and GBL in terms of the conventional MFI metrics of takeup and repayment.
- Policy makers should use the existing economic links within the community. Economic links appear to work better than social and political networks.
- Different means of credit delivery should be used to target different segments of the population - there is *no one size fits all policy*. GBL and AIL could be offered at the same time, with poorest (landless, minority caste and religion) households self-selecting into GBL contracts, while small and marginal landowners are more likely to be recommended under AIL.

Implementation

Harness local information and social capital. If there are individuals within the local community with information concerning creditworthiness of borrowers and with some ability to impose sanctions on non-performers, these individuals could be appointed as loan intermediaries.

How to appoint the loan intermediary agent is an important question, since the selection process is likely to be very different depending on who the agent is. Our results then contribute substantially to the debate as to who should be appointed as an agent. Policy makers are rightly concerned with the power and influence these agents or intermediaries are likely to wield and the consequences of the abuse of such power. In our experiment we consider two categories of potential agents: traders (TRAIL), and those recommended by the local government or village council/gram panchayat (GRAIL). The two types of agents have very different kinds of links with potential borrowers: the former mainly economic links, while the latter have social and political links.

Dissemination

To the Reserve Bank of India, Finance Ministry of Government of India and of West Bengal (where this project has been conducted), corresponding regulatory institutions in other countries in Asia, Africa and Latin America, various microfinance institutions, microfinance communities and blogs, academic researchers in development finance, MFI-funding institutions.

Further Reading

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Pushkar Maitra is a Professor Economics at Monash University. His primary research interests include Development Economics, Population Economics, Applied Econometrics and Behavioural Economics. His specific research interests are analysis of poverty and welfare in developing countries; health, education and human capital accumulation; fertility, mortality and gender preference with special focus on South Africa and South Asia.

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