Collective Action, Social Capital and Group Lending

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For low-income households with meager assets, financial services that could potentially augment their income are of extreme importance. Financial mechanisms that could facilitate asset build-up, protect against risks, and sustain livelihoods of poor people would go a long way in improving their living conditions and social status. Microfinance is one such financial mechanism that caters to poorer and marginal households and communities.

One of the best known innovations in microfinance is group lending, pioneered by the Grameen Bank of Bangladesh. This has been adapted by the Banco Sol of Bolivia, FINCA of El Salvador, and many other organizations around the world. Group size can vary from as few as three members to as many as 50. What is common across the approach is the concept of group responsibility — sometimes called joint liability — coupled with regular group meetings.

Group lending has succeeded where traditional banks have failed, bringing credit to the poor and to earning Grameen-Bank founder Muhammad Yunus a Nobel Peace Prize in 2006. Notwithstanding these achievements, it is important to note that there are also risks associated with group lending, both for the lender and the borrower, and it is not appropriate for every context. Many recent microcredit schemes are not based on joint liability. Even so, collective action and social pressure can have a positive influence on the performance of microcredit institutions.

What Makes Group Lending Successful

When the Grameen Bank first got started as an experimental bank in the village of Jobra, near Chittagong University in Bangladesh, the first loans were made to individuals without a group responsibility clause. Economies of scale motivated the first use of groups; however, it was quickly discovered that organizing the borrowers in groups not only reduced the bank's administrative costs, it also improved the performance of loans.

Joint liability means that group members have the incentive to monitor each other and use social pressure to ensure that borrowed money is invested wisely and repaid. In an extreme case, group members may even take responsibility for payment of their co-members' delinquent loans to ensure their own future supply of credit.

> **Group Lending and Joint Liability**
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> ***Group lending*** refers specifically to arrangements through which individuals without collateral get together and form groups with the aim of obtaining loans from a lender. Loans are made to individual group members but the whole group faces consequences if any member runs into serious repayment difficulties, a practice known as ***joint liability***.

Another reason why groups can make lending more attractive for both lenders and borrowers is that when groups form on their own, safe borrowers who are likely to repay can form groups with other safe borrowers, thereby reducing their risk of having to repay someone else's loan. Risky borrowers are left to group with others who are also more likely to default. It has been shown that this "assortative matching" of borrowers into two types of homogenous groups can improve the efficiency of lending, reduce defaults, and allow banks to charge lower interest rates to all borrowers.

Even when groups are formed randomly or by people who do not know each other well, as often happens in big cities or in areas where people are highly mobile, group lending can still improve performance if risky borrowers, when lucky, get higher returns for their investments than safe borrowers who invest more conservatively.

Many empirical studies have, in fact, shown that self-formed groups do not necessarily perform better than randomly formed groups. Similarly, groups made up of people with close social ties do not always do better than groups of strangers. While this may sound counterintuitive, family, and

friendship ties are unlikely to correlate strongly with whether people are both risky or safe borrowers, and friends are more likely to understand and forgive when friends default due to difficulties beyond their control.

While there is no doubt that group lending can bring benefits to both borrowers and lenders in certain contexts, it is important to keep in mind that there are costs and risks involved. Group lending often relies on the fact that it is easy for group members to monitor each other's behavior and to meet regularly. This is often not the case, especially for the poor.

Group Lending: Moral Hazard and Adverse Selection

Moral hazard is the incentive a borrower has to use a loan for unproductive or risky projects or to not repay even if she is able. It is reduced in group lending through peer monitoring. Members of the group and the broader community can easily observe whether borrowers are using their loans appropriately.

Adverse selection occurs when banks cannot distinguish between safe and risky borrowers and offer the same high interest terms to each type of borrower, discouraging safe borrowers from applying. This is reduced in group lending when the members of the group know this information about each other and self-organize into groups accordingly.

In addition, using social pressure to encourage good behavior is risky if it leads vulnerable borrowers to take extreme measures to avoid default, or results in social exclusion and marginalization when default becomes inevitable. Given that group lending is most attractive for the very poor, the risk of furthering the vulnerability and marginalization through such processes should be taken seriously. In fact, some microlenders are exploring ways to support troubled borrowers without jeopardizing the standing of the entire group, which can lead to better outcomes, both economically and socially.

Beyond Joint Liability

While the number of cases in which joint liability is optimal may be limited, there are other ways in which groups and social pressure can improve efficiency and performance of microlending even to individuals.

- Where borrowers know each other well, lenders can use groups as a way to find out information about individual potential borrowers. This practice, known as cross-reporting, is an efficient way for banks to get information about their clients' reliability. Borrowers have the incentive to provide reliable information to ensure their own future credit access.

- Repayment in groups can increase repayment rates because requiring borrowers to repay publicly can provide the incentive to pay and avoid social stigma (as well as reduce the possibility of financial irregularities on the side of the lender).

- Meeting borrowers in clusters in scheduled locations and at scheduled times reduces transaction costs, though it could add to borrower costs.

- Group meetings can facilitate education and training, which may be particularly helpful for clients with little business experience and/or low literacy levels. Education may aid financial performance or it might be valued intrinsically as a way to improve levels of health and knowledge.

- Clients who have no prior experience with commercial banks may feel more comfortable approaching a microfinance institution as part of a group.

Conclusions

Group lending can reach people who lack the assets to make them clients for traditional banks. Successful group lending schemes do not necessarily require that people know and trust each other but that they can monitor each other's behavior relatively easily. Where this is not true, group lending may not work.

Joint liability lending can provide powerful incentives for borrowers to use their loans wisely and repay. However, there is always a risk that constructive social pressure becomes destructive social domination or social exclusion, in which case lenders need to be conscious of the risks that borrowers could face. Even without joint liability, there can be benefits to micro-lending through groups.

Suggested Readings

Armendáriz de Aghion, B. and J. Morduch. 2000. *Microfinance Beyond Group Lending*. Economics of Transition 8 (2): 401-420.

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Karlan, D. 2005. *Using Experimental Economics to Measure Social Capital and Predict Real Financial Decisions.* American Economic Review 95(5): 1688-1699.

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