

Title: Intermediated Loans: A New Approach to Microfinance

Authors: Pushkar Maitra (Monash University), Sandip Mitra (Indian Statistical Institute), Dilip Mookherjee (Boston University), Alberto Motta (University of New South Wales) and Sujata Visaria (Hong Kong University of Science and Technology)

Policy Motivation for Research:

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.

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.

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:

1. Armend_ariz, B., and J. Morduch (2005): *The Economics of Microfinance*. MIT Press, Cambridge, MA.
2. Banerjee, A., E. Duflo, R. Glennerster, and C. Kinnan (2011): "The miracle of microfinance? Evidence from a randomized evaluation," Mimeo, MIT, JPAL.
3. Banerjee, A. V., and E. Duflo (2011): *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*. Public Affairs.
4. Karlan, D., and S. Mullainathan (2010): "Rigidity in Microfinancing: Can One Size Fit All?," Discussion paper, QFinance.
5. Srinivasan, N. (2008): *Microfinance India. State of the Sector Report*. SAGE.