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RURAL FINANCIAL POLICIES for FOOD SECURITY of the POOR

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Design and Sustainability Issues of Rural Credit and Savings Programs: Findings From Malawi

ALIOU DIAGNE

RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

ABOUT THE AUTHOR

Aliou Diagne is formerly a visiting research fellow of the Food Consumption and Nutrition Division at IFPRI.

Joint liability group lending is currently the lending technology of choice of microfinance institutions because of the success of the Grameen Bank, which is using the technology to successfully lend to millions of poor Bangladeshi women. It is widely believed that the incentives for peer-selection, peer-monitoring, and peer pressure resulting from the joint liability clause are responsible for the high repayment rates of the Grameen Bank and other similar microfinance institutions. The analysis and findings presented in this brief are the results of research undertaken by the International Food Policy Research Institute (IFPRI) and Bunda College of Agriculture on the practice and performance of joint liability group lending in Malawi. This research provides evidence on the extent to which peer selection, peer monitoring, and peer pressure are taking place in the credit groups affiliated to the Malawi Rural Finance Company (MRFC), the main microfinance institution in Malawi, and their impact on the joint liability on loan repayment.

The empirical findings of the study contrast with the conventional wisdom and assumptions regarding the informational advantage of the joint liability and its implications for incentives for peer selection, peer monitoring, peer pressure, and loan repayment. In particular, the findings do not support the widely held presumption that joint liability is responsible for the high repayment rates of the successful group lending programs. In fact, the study finds a negative impact of the joint liability clause on the repayment outcomes of MRFC credit groups. The main findings and policy implications of the report are summarized below.

1. The relative value that borrowers attach to access to future credit is found to be the most important factor that motivates them to repay their loans and that of defaulters in their groups. The average amount MRFC borrowers are willing to pay in order to maintain their access to credit is found to be 523 Malawi kwacha (about US$12) or 24 percent of the average loan size per member. This is more than the 15 percent up-front cash deposit that the MRFC seasonal agricultural group members are required to pay. Hence, the findings demonstrate that a lending policy of gradually increasing the loan sizes of good and repeat borrowers (which increases the value of maintaining future access to credit) will have a positive impact on repayment rates and that higher interest rates (which increase both the value of defaulting on a current loan and that of the defaulted loans that must be repaid by nondefaulters under the joint liability rule) will have a negative impact on repayment rates.

2. Peer selection is very limited in MRFC credit groups because of the significant influence that extension workers, credit assistants, and village authorities have on the formation and composition of MRFC credit groups. The study found that 90 percent of the groups include members from families of their respective village authorities. In terms of wealth, MRFC credit group members are also found to be, on average, the same or richer than the rest of the population in their respective villages. These findings imply that powerless ordinary village residents are in a situation where, often, their only choice is either joining the only credit group in the village in which they have very little or influence on its membership composition, or be without credit.

3. Not much effective peer monitoring is taking place in MRFC credit groups because of the non-pecuniary "social cost" associated with it. For example, the lack of effectiveness of the group monitoring committees has been attributed to the fact that committee members are usually fearful of being seen by other members as spying on or interfering

INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE
2033 K STREET, NW, WASHINGTON, DC 20006-1002 USA
Web: www.ifpri.org • Phone: 1-202-862-5600 • Fax: 1-202-467-4439 • Email: ifpri@cgiar.org

with other members' private businesses. Another explanation for the relatively limited peer monitoring is provided by the fact that MRFC credit group members are usually from more than one village (three on average). But, even when an effective peer monitoring takes place, its effect on loan repayment is not as important as it is believed to be because the main reason for default in MRFC credit groups is *unwillingness* to repay and not *inability* to repay. Indeed, *unwillingness* to repay is found to be the first cause of default in MRFC credit groups (25 percent of all defaults). Furthermore, the analysis of the reasons for default in MRFC credit groups shows that at most, 37 percent of the defaults in MRFC credit groups could have been possibly prevented by a more effective peer monitoring.

4. The monitoring activities of extension workers are very important for the well functioning and performance of MRFC credit groups. Extension workers play an important role, for example, in ensuring that in-kind loan packages, consisting mostly of fertilizer and seed, are not resold by borrowers. In the case of tobacco farmers, they are also involved in ensuring that all group members send their harvested tobacco on time to the tobacco auction floors instead of selling them to intermediate buyers. This part of their monitoring work is very important for MRFC because of its arrangements with the auction floors that allow MRFC to deduct the amounts owed by tobacco groups directly from the proceeds of their tobacco sales. Monitoring activities are usually undertaken in conjunction with their extension work and extension workers have strong incentives to give special attention to the credit groups in their sections because of the way they are rewarded in their jobs.

5. Peer pressure takes place less frequently than implied by the joint liability, and when it does take place, it is more likely to fail than to succeed in inducing defaulters to repay their loans. The relatively few instances of use of peer pressure are explained by the nonnegligible "social costs" that nondefaulters incur when they peer pressure defaulters. The evidence indicates that active peer pressure serves more as a credible mechanism for good borrowers to signal to future potential defaulters their willingness to apply peer pressure than a mechanism for recovering current defaulted loans.

6. Joint liability has negative impacts on the loan repayment of MRFC credit groups. The study found that MRFC groups that expected the joint liability not to be fully enforced performed much better in terms of repayment rates than groups in which the joint liability was expected to be fully enforced. The impact of the joint liability on enforcement is also found to worsen when some members have some doubt about the repayment intentions of other members in their groups—a situation that occurred in 62 percent of MRFC credit groups. Furthermore, the majority of the partially paid delinquent loans consist of good borrowers who are defaulting because of the joint-liability nature of contracts.

Conclusions

Based on the above findings, it is concluded that (1) the prominence given to the joint liability in explaining the high repayment rates does not hold up universally and (2) microfinance institutions targeted to poor people can operate successfully and achieve high loan recovery rates if they develop lending technologies that do not rely on collateral, but instead cultivate borrowers' expectations for higher and continuous access to credit, and establish an effective screening and monitoring system using their field staff. Empirical findings also suggest that joint liability can have a negative impact on loan repayment. This calls for institutions such as the MRFC to reconsider its inflexible *full* group joint liability policy (no new loans to any borrower until all loans are repaid), an arrangement generally disliked by the majority of its borrowers. It is recommended that MRFC adopt a *limited* group joint liability policy in which defaulters are excluded from the groups and nondefaulters are issued new loans when they pay a reasonable monetary penalty not tied to the total amounts of the defaulted loans. This more flexible group joint liability policy has the potential to yield both lower delinquency rates while retaining most of the cost-saving advantages of lending through groups. Finally, it is important to note that the proposed *limited* joint liability policy is different from a simple relaxation of the *full* joint liability in that it does not penalize nondefaulters in defaulting groups. Such simple relaxation—which usually takes the form of a policy of issuing new loans to nondefaulters in groups with repayment rates above some threshold value—has been experimented with in Malawi under the SACA program during the late 1980s and early 1990s with poor results. ■

Selected Reference

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ABOUT IFPRI

IFPRI's mission is to identify and analyze strategies for meeting food needs of the developing world, with particular emphasis on low-income countries and the poor.

IFPRI is a member of the Consultative Group on International Agricultural Research (CGIAR).

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CONTACT
Bonnie McClafferty
Communications Specialist
B.McClafferty@CGIAR.ORG