

Transmittal Group Lending Model as an Innovative Alternative for Managing Risk and Reducing Cost in Micro- Lending

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Abstract

The relevance of micro-lending in battling poverty and encouraging sustainability of the poor is more vividly seen after the emergence of Bangladesh-based Grameen Bank as a successful microfinance institution in 2006. Creating a sustainable microfinance institution largely depends on the two important factors; cost and risk. This paper examines the common risks and costs associated with micro lending, vis-à-vis the trade-off that results into higher costs the more risks are well managed, and higher risks the more costs are highly reduced. As the popular 'group lending' model is patronised by the majority MFIs around the world, this paper has gone beyond to suggest the adoption of a new concept in group lending management; the Transmittal Lending model. This new model is theoretically described to optimise the two conflicting variables of risk and costs, so as to enhance an MFI's profitability and sustainability, simultaneously. The general methodology applied is a review on relevant literature so as to find previously established research opinions that will support the new group lending model. Nevertheless, this new model needs to be quantitatively tested by researchers in the field to deeply understand the dynamics of its applicability in the industry.

Keywords: Microcredit, group lending, transmittal lending, risk management, cost reduction

Introduction

Immediately after the advent of the 2008 global economic crisis, corporations and individuals are seen to brainstorm for better alternatives and reliable shelters to guard against the worsening effects of such occurrences in the future and alleviate the adverse effects caused by the most recent crisis. Crisis like this may affect the way and manner financial institutions grant credit facilities to individuals and organisations and to a larger extent the way risk and cost of credits are managed is

taking a different dimension – a position that commonly satisfies lenders than borrowers. In this peculiar situation the search for a feasible solution in terms of reduction in both the cost and the risk of lending is needed to allow the continual performance of the microfinance institution in servicing the poor and the SMEs.

The increasing number of those who directly or indirectly lose their jobs due to the outcomes of the crisis is on the high side (Hall, 2010) and this translates into many of them turning to entrepreneurship as the only available and viable option, hence more pressure on the financial services providers at the micro-level in order to profitably satisfy this emerging market niche. As much as this new market is proposing an expansionary opportunity, so it is signalling the need for a more creative and sound risk management with an optimal cost management for the microfinance institutions granting these loans. Until innovative ways of managing the two important factors in loan management are sought, capital for the lower segment of the society would be tighter to access and this may later translate into low financial inclusion and higher poverty incidences in a typical society.

The objective of this research is to discover the next alternative to group lending – from the existing literature - that would enhance loan repayment with lower risk and at lower cost. Doing so will pave way for the practitioners to experiment the suggested third alternative, that is the ‘transmittal lending’ technique as a new process for effective micro-lending.

The key research question is that; can a new method of micro-lending be devised to achieve the dual objectives of lowering both risks and costs optimally? Qualitative arguments are therefore used to find support or otherwise to this premise.

Linkage of Savings with Micro-lending

Micro-financing involves the procedures for the provision of financial services to low-income people who are either in employment or self-employed. The commonest microfinance services offered are savings and micro-lending (Ledgerwood, 1999). The fact the poor have little or nothing to save in times of economic hardships proves the reason for the bigger popularity and relevance of micro-credit to the poor over savings. Rotating savings and credit (called *dashi* in Hausa) is a popular method of informally converting savings into loans to members of a thrift society in a rotational fashion (Harper, 2002). This emphasises the fact that the poor commonly saves to earn the opportunity for getting micro-loans higher than what he can save at any particular point in time. In addition to this, the group lending model emerged from the life experience of the Grameen Bank – when micro-loans were issued to solidarity groups of 4 to 7 and proved effective in deterring defaults as evidenced by the higher repayment rates recorded at that time (Berenbach & Guzman, 1994). This model is based on cross guarantee of individual members against possible default by any member.

In a typical micro-lending scenario where is to be managed well, cash flow based lending is more applied than asset based lending going by the fact that if a client is to be assessed on his/her assets owned, majority of applicants would not qualify. Whereas the cash flow based lending is much more oriented to the business potential and capabilities of the client and as such a better way of understanding future repayment risks. In trying to manage lending risks effectively, microfinance

institutions consider a conglomerate of criteria before and after credit decisions are made. In practice, popular pre-credit decision factors may include; character and commitment of the borrower (motivation to repay), business viability of the borrower, cash flow coverage and the applicant's contingency plan in case of default. Post credit decision risk factors may include; regular checks on loan sheets, in-depth portfolio monitoring, continuous contact with the client, reduction of monitoring costs, etc.

Group Lending, Defaults and Loan Supervision

In theory, dealing with defaults can be through a number of means to allow a microfinance institution realise the outstanding credits to a measurable higher extent as close to 100% as possible. Group liability in case of default is one of the popular means of managing defaults which implies that this method could only be practised where a loan is issued through the 'group lending approach'. The group liability may in many cases be seen as weak especially in the situation whereby the economic position of group members from where a defaulting member emanates may not be financial buoyant to pay for the defaulted amounts and going by the increase in amounts due to interest compounding. The existing group lending practices are tied to excessive costs of joint liability to members of a group (Aghion & Morduch, 2000), which implies the tendency for the group members to default honouring the promised liability. This is clearly pointing to the fact that for a micro-loan to be efficient pattern of enhanced repayment possibility is needed more than the 'group guarantee' many micro-lenders heavily leverage on.

According to Bichanga & Aseyo (2013), non-supervision of borrowers by lenders is a key factor resulting to credit defaults in micro-lending. They also perceived that if borrowers have inadequate assets value at the time they take on loans, expenditure is typically allocated to household consumption than loan repayment due to the desire to have decent survival by the borrowers. But to be profitable, supervision and monitoring costs need to go down.

Despite the popularity of group lending in the industry today, some scholars either feel the superiority of individual lending and its promise (Lehner, 2009; Kono, 2007) or believe there's not much difference between the two (Gine & Karlan, 2011). Lehner (2009) uses statistical modelling for prediction and found that microfinance institutions (MFIs) are only likely to offer group loans when a loan size is large, refinancing costs are high and competition between MFIs is low, otherwise individual loans are offered instead.

Issues on Effective Cost and Risk Management in Microcredit

Based on past works (Shankar, 2007) transaction costs are the most important contributing factor that leads to higher interest rates charged on microloans. In a study involving 3 MFIs that have an established economies of scale by having more than 10,000 clients in North and South India, it was found that there are 3 main types of transaction costs incurred by micro-lending MFIs; Direct, Indirect and life cycle transaction costs. The most controllable one – the direct cost – is highly driven by the cost of field worker compensation, especially the loan recovery activity which takes more than the group formation and administration costs.

By implication, to reduce the overall cost of lending an MFI must significantly work to reduce the cost of recovery by instituting creative means that would ensure the deployment of as little the number of its field workers as possible.

Natamba, B. et al (2013) also argues that costs of transactions are an important factor in determining not only the sustainability of an MFI but also its growth potential. In a study involving 286 respondents from 30 MFIs in Uganda, it was confirmed that there exists an established positive relationship between transaction costs of MFIs and their client outreach. They further asserted that monitoring costs of credits are an important component of the overall cost structure of an MFI. This also points to the need for the development of workable options that would ensure significant drop in the cost of field workers engaged without negatively affecting the risk portfolio of the borrowers.

Achieving cost efficiency through reduction of cost of group formation in micro-lending is viewed by Marakkath, N. (2012) as an important component that would yield Operationally-self sustainability (OSS) in MFIs. In his study research on an existing MFI in India, she gathered that the strategy of outsourcing group formation to Non-Governmental Organisations (NGOs) with relevant core competence is one sure way of reducing costs of group formations and trainings. In the case study, she discovers that the MFI only paid about 5% of its actual cost of group formation in the form of outsourcing fees. This cost has the potential for rising much higher than this but in general, there would still be obvious cost savings.

The need to effectively manage credit risks in micro-lending especially those managed through group lending is obvious. MFIs can succeed in reaching the poorest of the poor at comfortable/acceptable risk levels by devising innovative strategies in group lending (Ibtissem, B. et al, 2013). This goes with the tone of this paper in that it seeks to identify transmittal lending as an innovation of the group lending model practiced commonly amongst MFIs.

As microfinance banks strive to survive and consequently make impact on the lives of the poor, it has been established that a majority of them scantily understood and poorly apply operational risk management principles (Mago et al, 2013). Accordingly, a good number of those who practice credit risk management strategies are proved to be less efficient in doing so.

Social Collateral, Joint Liability and Loan Repayment

As microfinance offers the finance discipline a possible avenue to improve the lives of millions of poor people (Brau & Woller, 2004; Beatriz & Morduch, 2000), supporting literature suggests that joint liability in micro lending poses the tendency for the creation of ‘free riders’ and hence reduces repayment rates (Kono, 2007). This argument is contradicted by the works of Gomez & Santor (2008), who using a modelling technique conclude that group lending out-performs the conventional individual lending techniques in terms of repayment success. But this perceived success is attributable to the quality of the loan manager, level of trust within a group, and the enforcement of social norms within and surrounding the group. Social collateral works through reputational effects on group member, thereby signifying that so long as social collateral will be strongly established as an ingredient of joint liability, borrowers are most often likely to repay than not (Brau & Woller, 2004). In addition, an individual’s repayment tendency in a group depends more on the homogenous behaviour of the group (Sorangi et al, 2004 & Chowdhury, 2007). The probability that a member of a group making full repayment will be 15% higher if all fellow

members make full payment, as compared to the case where none of the members have paid in full (Li et al, 2009).

Methodology

The research is based solely on the analysis and review of literature surrounding the topic. Implied deductions are made from existing findings to enable a more guided argument on the subject matter.

Selection of the review method at this level is informed by the very fact that the proposed new model is still at its concept development stage with no any existing evidence of application of such model in practice.

Discussions and Conclusion

Analysis of past research works in the area of micro-lending have confirmed the relevance and efficiency of group lending especially in ensuring higher loan repayment rates (Chowdhury, 2007). In effect, there are some exceptions as to the form and content of group lending applied in any particular case. For example, group lending that relies on cross guarantee and cross liability may seem not yielding as much as if the lending is hedged with social pressure techniques (social collateral) that seek to punish the defaulter rather than force those who hold joint account to bear the default costs.

A remarkable advancement from the common group lending is the advent of ‘sequential lending’ and ‘simultaneous lending’ techniques. Sequential lending seeks to manage the risk of default by allowing loans to be granted to group members in a sequential order, thereby allowing for revolving the same unit of capital to the entire group members but at different times and only after successful performance of previous loanees. On the other hand, simultaneous lending allows more than one group member to take on loans but with joint liability. In these cases, the main subject of concern is risk management. And thus the majority of the methods applied today in the industry are focusing more on risk management as a factor for sustainability. But looking at the high cost of loan management in micro-lending, it becomes imperative to come up with an advanced thought in group lending that would incorporate both risk management and cost reduction so much so that sustainability would be more rooted when profitability is also enhanced after risks are adequately managed. This leads to the emergence of the next alternative, the transmittal lending technique.

Transmittal lending is coined from the word ‘transmission’ - laterally the act of sending or conveying something from one person, place or thing to another. This is a form of group lending that tries to optimise both risk management and cost reduction by creating a system that transfers loans from one group to another in a semi-direct way so that the group collecting a new loan would have to be in contact with the group(s) repaying an old loan within the same community strata. In designing a transmittal lending system, the community in question would have to be divided into a form of homogeneous strata within the heterogeneous population, which would give the opportunity by granting loans to people with near similar economic condition, social relations and

cultural beliefs. The anticipated result from this arrangement is that the new group collecting loans from the old group would effectively support the microfinance institution in the following manners;

- i. Supervision of loan repayment from the repaying group thereby reduction in cost of supervision by the MFI and reduction in the risk of default
- ii. Social pressure on the repaying group especially from the new loaning group in the case of repayment delay or intentional default
- iii. Involvement of the repaying group on the process of deciding on granting loans to the new groups would make the repaying group feel more responsible to the success of the MFI and would have a sense of ownership in the MFI and would help an MFI get a good assessment of the new lenders. This feeling would significantly reduce the risk of default from the repaying group.
- iv. Since the arrangement in transmittal lending is such that the repaying group are to pay directly into the bank account of the newly approved loan group, the high cost of monitoring repayments would be significantly reduced as the majority part of this task would be handled by the new loan group.

It is now conclusive that after the much controversy surrounding the effectiveness of group lending, transmittal lending may not only enhance repayments but could optimally control both the risk and cost of borrowing in MFIs. I also predicted that transmittal lending would only be efficient by stratifying heterogeneous population into homogeneous subgroups.

It is recommended that Nigerian MFIs should take the challenge of testing the practicability of the transmittal lending model as a means of improving their performance and sustainability. Outputs should then be measured against investments in this model to come up with workable data to test the extent of its efficiency. If this model could be practically proved, then the MFI industry would impliedly be led by this and further innovations in loan management and control.

Research Limitations and Directions for Further Research

The concept of transmittal group lending is at the theoretical foundation level now. This review is limited to theoretical hypothesis on the feasibility of this lending model to optimise both transaction costs and credit risks. Thus, the model should be subjected to practical testing by practitioners and future researchers so as to deeply understand the relevance of its applicability and the extent to which both costs and risks are optimised under different environmental conditions.

Further research may also seek to establish the legality as well as the legal implications of transmitting loans directly from a repaying party to the awarding party.

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