

EXPLAINING THE WIDESPREAD SUCCESS OF GRAMEEN BANK-STYLE 'MICROLENDING'

Eight to ten million households across the world benefit from 'microlending' programmes of the kind pioneered by the Grameen Bank of Bangladesh. And default rates for Grameen fall in the range of 2-8% compared to 60-70% for more conventional loans. New research by **Maitreesh Ghatak**, published in the latest *Economic Journal*, explains this apparent miracle in terms of the benefits of peer group pressure.

The root of the problem that the Grameen Bank and comparable institutions tackle is that because they cannot offer collateral, the poor in underdeveloped countries are unable to borrow from formal lending institutions. This means that they are forced to remain in low return occupations that do not require much capital - the classic instance of what economists call a 'poverty trap'. Microlending institutions offer a way out of this impasse by using unconventional methods to lend successfully to poor people who cannot provide collateral.

Of these, the most famous is the Grameen Bank. Beginning its operations on a very small scale in 1976, membership of the bank exceeded two million borrowers by 1996, most of them poor women from rural areas. Estimates of the default rate under the bank's group-lending programme have been in the range of 2-8% compared to 60-70% for comparable loans by conventional lending institutions. Indeed, the bank has become a role model for lending programmes to the poor used by government agencies and NGOs all over the world. Today, there are eight to ten million households served by similar lending programmes, including many in the United States.

How can this apparent miracle be explained? The answer, according to Ghatak, lies in several distinctive features of the Grameen Bank's group-lending programme that help it to reduce the transaction costs associated with lending. In particular, borrowers are asked to form small self-selected groups from within the same village. Loans are given to individual group members, but the whole group is jointly liable for the repayment of each member's loan. Since borrowers from a given village are likely to have much better information about each other than an outside lender, the bank is able to induce the borrowers to screen out the bad risks using the instrument of joint liability.

This process reduces one of the major sources of transaction costs in banking - screening a borrower to ascertain what kind of a risk a potential borrower is. A lender can try to deal with this information problem directly, by trying to assess these characteristics, or indirectly by offering loan terms that only good risks will accept. The typical method used to separate good risks from bad risks is to ask the borrower to pledge collateral. Risky borrowers are likely to fail more often and lose their collateral.

Both methods are likely to be costly for lending to the rural poor in developing countries. A recent study by Signe-Mary McKernan, an economist at the US Federal Trade Commission, based on a large scale survey conducted in 87 villages in Bangladesh, provides evidence that a major cause behind the successful lending programme of the Grameen Bank is its ability to screen out bad credit risks.

The main idea of Ghatak's research - that local information among individuals in a neighbourhood or workplace can be used to provide simple solutions to informational problems - can also be applied to other contexts. One example is group health insurance in the United States, under which the premium paid by the members of a group, such as workers in a firm, depends on the size, demographic composition and, to some degree, on the average claims made by the whole group. This is referred to as partial (group) experience rating. Another potential application is preventing abuse of targeted programmes such as poverty alleviation or welfare.

A research report by **Beatriz Armendariz de Aghion** and **Christian Gollier** published in the same issue of the *Economic Journal* also focuses on microlending. It notes that most analysis of the phenomenon suggests that there are three conditions for poor borrowers to be able to access credit. First, that they should be well informed about each other, as is generally the case in small rural communities in developing countries. Second, that they are able to self-select themselves according to risk and return characteristics. And third, that they form peer groups within which each borrower must hold him or herself responsible for the entire group loan.

While still emphasising the importance of peer group lending, these researchers argue that *potential borrowers do not necessarily need to be informed about each other*. In particular, Grameen-type group lending can equally succeed in small rural communities where peer grouping is 'assortative', and in large urban areas where borrowers engage in group formation 'non-assortatively' and where therefore the borrowing population is highly heterogeneous.

Policies for making credit more accessible to the poor should not, these researchers conclude, be entirely focused on the rural poor because success can also be found elsewhere, namely, in more urban environments. The research suggests that as in their rural counterparts, interest rates among anonymous borrowers in cities can potentially be brought down from as high as 150% to 20% per annum.

Note for Editors: 'Screening by the Company You Keep: Joint Liability Lending and the Peer Selection Effect' by Maitreesh Ghatak and 'Peer Group Formation in an Adverse Selection Model' by Beatriz Armendariz de Aghion and Christian Gollier are published in the July 2000 issue of the *Economic Journal*. Ghatak is at the University of Chicago; Armendariz is at University College London; and Gollier is at the University of Toulouse.

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