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Commercialization and mission drift: Evidence from a large Chinese microfinance institution

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ABSTRACT

Front-line loan officers of microfinance institutions (MFIs) are important in acquiring information on potential borrowers and selecting them in accordance with the MFI's mission. We use a unique data set on loan officers and their loan portfolios from China's largest NGO microfinance institution to test whether officers' personal characteristics affect the size and quality of their loans. We study a period in which the institution shifted from reliance on government donations and subsidies to commercial sources of funding. Imposing more commercial incentives on loan officers could affect how they balance potentially competing objectives to serve the poor and pursue profitability. We find that loan officers who were formerly farmers or worked in local government were better able to maintain lending to poorer borrowers, without incurring substantially lower repayment rates on their loans. In short, it appears that the career backgrounds of loan officers did play a role in preventing mission drift.

1. Introduction

Since its inception, observers have speculated about the potential of microfinance to lift individuals and households out of poverty (Morduch, 1999). The "joint liability" contracts pioneered by the Grameen Bank were quickly replicated in many developing countries and, by 2006, microfinance loans had been received by over 100 million households in developing countries (Daley-Harris, 2007). Under these joint liability contracts, often referred to as group lending, members of the group use borrowed funds for their own purposes but all members are severally liable in the event of a default. Group members therefore have incentives to communicate with and monitor one another, and most group lending methods involve regular meetings. While these methods have achieved very high repayment rates on loans, borrowers may find them time consuming and not always well suited to their credit needs. We refer to these methods as 'group liability loans' in the rest of the paper.

Grameen founder Muhammad Yunus's original vision was that group liability loans would provide credit to support micro-entrepreneurs that would lift households out of poverty. While early research findings based on non-experimental methods indicated that use of microcredit brought about reductions in poverty (Pitt & Khandker, 1998), subsequent research based on field experiments

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suggests a more nuanced view. For example, based on analysis of six recent microcredit experiments designed to measure the same outcomes (but in different country contexts), Banerjee, Karlan, and Zinman (2015) find no evidence of transformative effects in terms of lifting households out of poverty.[1] However, the studies did show modest gains in the profitability and investment of microenterprises that were offered credit, and increased flexibility of choice in terms of occupation (wage labor or business owner), business scale, consumption (with a shift toward durables), female decision power, and improved risk management. These findings and conclusions echo those from a previous survey that covered a broader set of experimental papers (Banerjee, 2013). Moreover, research based on financial diaries (which track the financial lives of poor households at short intervals) indicate strong demand for microcredit, but as part of a patchwork portfolio of products from formal and informal providers that are stitched together because the incomes of the poor are small and irregular, and needs to access reasonably large sums (for health emergencies, weddings, funerals) inevitably arise (Collins, Morduch, Rutherford, & Ruthven, 2009). In short, while microcredit might not be a magic bullet in alleviating poverty, generally it has been shown to be a useful tool for poor households in managing their financial lives.[2]

While microcredit products have proved useful to poor households, the industry (or at least a sizable part of it) has moved beyond the relatively rigid group liability products introduced by Grameen. For example, Beck, Maimbo, Faye, and Triki (2011) note that African MFIs have shifted away from group liability lending mechanisms and, in West Africa, only individual liability loans are used. The trend toward individual liability lending has also coincided with greater reliance on commercial sources of funding (see discussion of commercialization in Morduch, 2000; Yunus, 2007; Cull, Demirguc-Kunt, & Morduch, 2009, 2011a). While there is little direct evidence, it stands to reason that the market-based returns that commercial funding requires provide a strong incentive for MFIs to make larger loans to somewhat wealthier borrowers. Those loans are more cost-effective per dollar lent and thus contribute to greater financial sustainability for the commercially-oriented MFIs that specialize in them (Cull et al., 2009).

The increasing commercialization of microfinance has fueled debates about mis-targeting and mission drift, from serving the poor and promoting social inclusion to pursuit of profitability (Yunus, 2007). While there is some evidence that MFIs benefit somewhat wealthier households rather than the poorest in some developing country contexts (Coleman, 2006; Kondo, Orbeta, Dingcong, & Infantado, 2008; Takahashi, Higashikata, & Tsukada, 2010),[3] evidence from studies that use larger datasets from MFIs in many developing countries emphasize the diversity of approaches to outreach and profitability within the industry (Cull, Demirgüç-Kunt, & Morduch, 2007; Cull et al., 2009). In particular, NGO-based MFIs place greater emphasis on outreach and rely relatively heavily on donated funds to subsidize those efforts, in large part because operating expenses (per dollar lent) tend to be higher for institutions that make smaller loans and lend more to women since those market segments are harder to reach.[4] Outreach-oriented MFIs are also more likely than commercially-oriented MFIs to continue to make smaller loans and to lend to women when confronted with greater competition (Cull, Demirgüç-Kunt, & Morduch, 2014) or increased costs associated with regulatory compliance (Cull, Demirgüç-Kunt, & Morduch, 2011b). But while the tension between the financial sustainability and depth of outreach of microfinance programs has long been a topic of interest and concern among researchers (Hermes & Lensink, 2011), the largest empirical study of mission drift found little evidence that average loan sizes had increased over time for a sample of 379 MFIs in 74 countries from 1998 to 2008 (Mersland & Øystein Strøm, 2010).

Under the microfinance model that we study, loans are uncollateralized and applicants have limited (or no) credit histories. MFI loan officers therefore obtain client information through site visits to the home or business of a prospective applicant, and through interviews with applicants and their references. MFI loan officers therefore rely heavily on their own judgment and expertise based on the "soft" information (Schoar, 2014) that they glean from interviews and repeated interactions with borrowers over time in evaluating potential clients. Our working assumption, therefore, is that the backgrounds of individual loan officers (on which we have extensive information) could influence the way they evaluate applicants and the characteristics of the loans they extend.

Our research is related to an emerging strand of the literature on how incentive compensation schemes affect the lending decisions of microfinance loan officers. Aubert, Janvry, and Sadoulet (2009) discuss the widespread introduction of incentive wage schemes among MFIs, and develop a theoretical model in which non-profit ('pro-poor') MFIs are unable to obtain a selection of only poor borrowers with loan officer incentives based on loan repayment. Because borrower wealth and the likelihood of repayment are positively correlated, loan officers have an incentive to switch their focus to wealthier borrowers, unless that incentive is checked by others that compel them to seek out information on whether applicants are poor (such as random audits on the wealth of borrowers selected by agents). Based on hypothetical comparisons by loan officers between loan applicants with different personal characteristics, empirical evidence from Burundi confirms that the poor are only slightly more likely to receive a micro loan, and that the lending preferences of loan officers from non-profit and for-profit MFIs are remarkably similar in terms of the characteristics of applicants that tend to be approved (Sagamba, Shchetinin, & Yusupov, 2013).

[1] Those authors acknowledge that failure to find significant effects could stem from the design of the experiments themselves. Take-up of microcredit products was low and unpredictable (in a statistical sense). The resulting lack of statistical power to detect potentially significant effects remains an important challenge in field experiments designed to identify microcredit impacts on poor households (Banerjee et al., 2015).

[2] And experimental evidence on microsavings products has shown them to be effective in helping poor entrepreneurs to protect profits and grow their businesses (see, e.g., Dupas & Robinson, 2013 for evidence from Kenya).

[3] For example, Coleman (2006) finds that participants in a credit program run by two NGO microfinance institutions in Northeast Thailand were significantly wealthier than nonparticipants prior to the program intervention. The difference in wealth was largely explained by the value of female-owned land across households.

[4] We follow this strand of the literature and use average loan size as our proxy for depth of outreach to poorer borrowers since the poor are likely to demand and receive smaller loans than wealthier borrowers. While this measure has limitations (see, e.g., Armendáriz & Szafarz, 2011), it is less likely to be misleading in a study of a single MFI over time (such as ours) than in a study comparing many MFIs located in different countries.