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Discrimination by microcredit officers: Theory and evidence on disability in Uganda☆

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ABSTRACT

This paper studies the relationship between a microfinance institution (MFI) and its loan officers when officers discriminate against a particular group of micro-entrepreneurs. Using survey data from Uganda, we provide evidence that loan officers are more biased than other employees against disabled micro-entrepreneurs. In line with the evidence, we build an agency model of a non-profit MFI and a biased loan officer in charge of granting loans. Since incentive schemes are costly and the MFI's budget is limited, the MFI faces a trade-off between combating discrimination and granting loans. We show that the optimal incentive premium is a non-decreasing function of the MFI's budget. Moreover, even a non-discriminatory welfare-maximizing MFI may let its loan officer discriminate, because eradicating discrimination would come at the cost of too many loans. Observing an MFI's loan allocation biased against a minority group therefore does not imply that the institution is biased against this group.

1. Introduction

Claiming that pro-poor microfinance institutions (MFIs) might discriminate against some micro-entrepreneurs may understandably sound like an oxymoron. Indeed, pro-poor MFIs consider providing financial services to the poor and the unbanked as a top priority (Hudon, 2009). Moreover, they are often sponsored by charitable foundations that take pride in their own good reputation. Those foundations would be put at risk if the institutions they support were suspected of discriminating against customers based on race, gender, or other characteristics. For these reasons, pro-poor MFIs are unlikely at first glance to purposely discriminate against sub-groups of their potential clientele.

However, evidence of discrimination in the credit market abounds. In an influential paper, Black, Schweitzer, and Mandell (1978) showed that race matters in mortgage loan allocation. Using information collected by the Federal Reserve Bank of Boston, Munnell, Tootell, Browne, and McEneaney (1992), Munnell, Tootell, Browne, and McEneaney (1996) spurred a large literature by finding that non-white applicants were significantly more likely to be denied a mortgage loan than white applicants with similar profiles. Discrimination is also detected in small-business lending. Cavalluzzo and Cavalluzzo (1998) find that businesses owned by Hispanics and blacks face higher loan denial rates than those owned by whites. Blanchflower, Levine, and Zimmerman (2003) report that black-owned small businesses are about twice as likely to

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be denied a loan as white-owned ones, holding all other factors constant. Cavalluzzo and Wolken (2005) and Blanchard, Zhao, and Yinger (2008) confirm those results.

Admittedly, this evidence originates in the U.S. There is, however, ground to believe that discrimination in credit allocation is also present in developing countries, where populations are often ethnically mixed and few legal barriers to discrimination exist[1]. Moreover, Buvinic and Berger (1990), Fletschner (2009), Agier and Szafarz (2013a,b), and Brana (2012) provide evidence that women are more credit-rationed than men by MFIs.

Several authors report that MFIs discriminate against disabled micro-entrepreneurs. Lewis (2004) stresses that businesswomen with disabilities in Zambia and Zimbabwe do not get access to microfinance services. Cramm and Finkenflügel (2008) and Bwire, Mersland, and Mukasa (2009) point out that discrimination by MFI staff is a major reason why disabled people find it hard to access microfinance. This is confirmed by a recent study by Beisland and Mersland (2012a) showing that 22% of economically active disabled persons do not approach MFIs for fear that the staff will reject them because of their disabilities.

Discrimination is a disappointing but acknowledged reality worldwide. Questioning its existence in microfinance not only makes sense; it is particularly relevant as poverty and discrimination often overlap (Patrinos, 2000), and access to credit has proved crucial to the poor. In addition, microfinance portfolios are known to exhibit biases in favor of some customers, such as traders and urban dwellers. Whether those biases originate from efficiency motivation or from bigotry among MFI staff is still mostly unexplored. As far as poverty alleviation is concerned, detecting discriminatory practices in microfinance is a major task, not only for researchers, but also for practitioners.

Addressing discrimination in micro-lending requires a precise definition to start from. The definition proposed by Schreiner, Cortes-Fontcuberta, Graham, Coetzee, and Vink (1996, p. 849) states that: "*Discrimination* is defined as providing smaller loans and/or providing loans with more stringent terms to borrowers who are identical with respect to creditworthiness but who differ with respect to characteristics unrelated to creditworthiness, such as race." This definition is somewhat restrictive, because creditworthiness is not the sole criterion used in micro-loan granting. Welfare-maximizing institutions such as MFIs have a double-bottom line (Tulchin, 2003), namely financial and social. Therefore, we have used a more general definition compatible both with mission statements and with financial constraints. In line with Dymski (2006), we define discriminatory micro-lending as denying loans more frequently and/or granting loans with more stringent terms on the basis of observable characteristics unrelated to both creditworthiness and the MFI's mission. For instance, if the MFI's mission is serving poor entrepreneurs, then the institution is said to discriminate against a specific group of borrowers if loans are granted to members of this group less easily and/or with harsher conditions than to other borrowers with similar levels of both poverty and creditworthiness.

Our definition has two dimensions. Given the possible interplay between both bottom lines, discrimination is trickier to detect in socially-oriented MFIs than in standard for-profit institutions. Consider, for instance, the case of discrimination against the disabled. First, within a pool of equally-poor micro-entrepreneurs, discrimination may lead to denying loans to some disabled applicants even though they are more creditworthy than non-disabled applicants who receive a loan. Second, within a pool of same-creditworthiness micro-entrepreneurs, discrimination may lead to favoring less poor applicants from the non-disabled group. In addition, discrimination may also arise from the combination of both these mechanisms (Agier & Szafarz, 2011). However, in such a case, at least one criterion must be strictly fulfilled since the trade-off between poverty and creditworthiness is MFI-specific, and cannot be attributed to discrimination.

Surprisingly, little academic research in microfinance takes discrimination as a main focus. This paper aims at filling this gap. We argue that discrimination in microfinance finds its origin in the decentralized governance of MFIs. MFIs are indeed highly decentralized. Typically, clientele selection is delegated to loan officers, who are poorly monitored, at least as far as their day-to-day work goes. Decentralization gives considerable leeway to loan officers, who spend up to 75% of their working time outside of the office (McKim & Hughart, 2005), and are difficult to monitor. This situation is reinforced by the wide demand-supply gap still existing in microfinance (Cull, Demirgüç-Kunt, & Morduch, 2009). If it exists, discrimination in microfinance could result from the behavior of loan officers. Since the managers of MFIs do not look at the personal characteristics of borrowers, discrimination by loan officers would remain undetected.

In this paper, we set up a formal model to investigate how a welfare-maximizing MFI may use incentive wage contracts to deter its loan officers from discriminating. Over the last decade, incentive pay has become increasingly common in MFIs (Développement International Desjardins, 2003; Holtmann & Grammling, 2005). The share of MFIs that resort to staff incentive schemes grew from 6% in 1990 to 63% in 2003 (McKim & Hughart, 2005). Nevertheless, existing incentive schemes are associated with financial output rather than with social mission, which makes them mostly inefficient against discriminatory practices.

To our knowledge, this paper is the first to draw the theoretical consequences of taste discrimination in a welfare-maximizing (as opposed to profit-maximizing) lending institution that does not have to cope with competition as a disciplining device. In particular, our model emphasizes that the MFI faces a trade-off between fighting discrimination and extending outreach, because incentive contracts are costly and the budget is limited. Welfare maximization may thus not imply complete eradication of discriminatory practices. In equilibrium the MFI may be better-off paying a smaller incentive premium, and letting its loan officers discriminate to some extent.

The paper is organized as follows. In the next section, we use data from Uganda, and report evidence that loan officers tend to discriminate more than other staff. Our results moreover suggest that discrimination is due to distaste rather than biased beliefs. In line with the evidence, we set up the model and draw its key implications in Section 3. Section 4 concludes.

2. Discrimination by loan officers: Evidence

In microfinance, loan officers play a key role in screening loan applicants[2]. They meet applicants face to face, and might therefore be inclined to discriminate against some of them. Although screening criteria are fairly standardized, loan officers are difficult to monitor. Owing to decentralization and poor supervision,

[1] Discriminatory practices have been exhibited in developing countries, notably India and in Latin America. In some cases, discrimination is direct: belonging to a given community generates social obligations and economic deprivation, as shown by Thorat (2002) with caste discrimination. In other cases, discrimination is indirect: lower human capital endowment is associated with lower access to education, causing a part of the population to be pushed into poorly-paid "dead-end jobs" (Knight, 1985). As stated by Patrinos (2000), indigenous, ethnic, racial, and linguistic minorities tend to be in an inferior economic and social position in comparison with the rest of the population.

[2] On the role of loan officers, see Fuentes (1996), Warning and Sadoulet (1998), Schreiner (2000), and Tchakoute-Tchuigoua (2012).