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SOCIAL AND FINANCIAL EXCLUSION: THE ROLE OF MICROFINANCE

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Abstract: Traditional banks have proved to have severe limits in mitigating financial exclusion. The microfinance revolution is intended to address this problem by devising new approaches which ease credit access for poor and uncollateralized borrowers. In this introductory essay we present a special issue of the *Rivista Italiana degli Economisti* on the role of microfinance in alleviating social and financial exclusion.

Keywords: Microfinance, Social Exclusion, Financial Exclusion.

JEL classification: G21, I30.

If the main function of financial intermediation is fueling the flow of financial resources from investors to the capital-poor agents with productive ideas, traditional intermediaries (banks) have proved to have severe limits in fulfilling it. The microfinance revolution is intended to address this problem by devising new approaches which ease credit access for uncollateralized borrowers who are traditionally prevented from it. Microfinance has been «reinvented» due to the popularity of Grameen bank practices in recent decades, but it is actually the heir of the secular wisdom of informal rural financial systems which have always tackled in one way or another the challenge of lending to poor uncollateralized borrowers. The most famous historical examples being those of *Raiffeisen* (agricultural) banks, which were initially established in Austria and Germany at the end of the nineteenth century[1], *tontines*, which were popular

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[1] With important – almost simultaneous – initiatives in other countries, e.g. predecessors of Rabobank in The Netherlands and Credit Agricole in France were established as mutuals and agricultural banks at the end of the 19th century.

in Europe and the US in the eighteenth and nineteenth centuries and operate nowadays in French-speaking countries in Africa, and *rotating savings and credit associations* (ROSCAs), which operate mainly in Africa and Asia to promote financial services for low-income individuals. Like in the case of community management of common pool resources studied by Nobel Prize winner Elanor Ostrom (2000), the success of these organizations is strictly related to the existence of a set of conditions that ensure that cooperative behaviors driven by social norms prevail against the incentive to deviate based on individual rationality.

The difference between the old and modern microfinance is the approach to the problem of the lack of collateral. While the best-known solution adopted by MFIs is certainly group lending with a joint liability clause, there are many MFIs which actually do not follow this approach. In this perspective, the academic debate on the pros and cons of group lending with joint liability has become a major topic in the microfinance literature. As is well known, group lending is aimed at solving the interim hidden action and the ex post hidden information problem in the lending relationship under asymmetric information (Murdoch 1999; Ghatak and Guinnane 1999; Gangopadhya, Ghatak and Lensink 2005). Group lending solves such informational problems by delegating the screening and ex post verification activities to the borrower peers who should suffer less from information asymmetry with respect to financial institutions. This reduces the lending risk for the MIF but is to the detriment of borrowers who are called to bear additional monitoring costs and the burden of the joint liability clause, which forces them to repay part or all the loan of the groupmate in case of insolvency. This is the reason why group lending with joint liability definitely improves the welfare of the bank but not necessarily the wellbeing of borrowers (the latter depending on the trade-off between the above-mentioned extra burdens and the reduction in lending rates if the bank transfer gains from risk reduction on borrowers).

Thus, some of the microfinance pioneers, such as Grameen Bank and Bancosol, have gradually abandoned group lending with joint liability and moved to individual-based contracts, where the problem of the lack of individual collateral is solved by alternative mechanisms such as progressive loans (according to which loans are given at the individual level in small installments provided that any previous installment obligation has been met by the borrower), notional collateral (according to which borrowers are required to pledge collateral goods that have affective or economic value for them, even if not for the market) and forced savings (according to which borrowers are obliged to accumulate month by month small amount of money with the objective of strengthening their saving discipline and creating a collateral for the bank in case of default.

The paper of Giorgia Barboni in this special issue has the merit of shedding new light on the group lending debate and on the relative pros and cons of joint liability versus individual lending contracts in solving the ex ante asymmetric information problem of project selection. As is well known, the assortative matching result in the literature indicates that group lending with joint liability is expected to produce a virtuous selection of good borrowers when the latter have rudimentary project revenue distributions and are ranked on the probability of default (even though we know that this result is not guaranteed when only low quality borrowers remain in the market). Barboni's paper, however, demonstrates that this is not the case when borrowers compete with each other to obtain the loan by «offering» to the lender a higher joint liability repayment as a signal of their quality. In this case the result is exactly the opposite and group lending generates adverse selection. The theoretical findings of the paper are then tested and validated with a small experiment. This paper therefore contributes significantly to the literature in that it provides a novel rationale for the observed departure of many outstanding microfinance organizations from the group lending/joint liability practice.

The most recent literature has emphasized the importance of educating people to save, as it has become apparent that one of the fundamental insights on the success of microfinance organizations is that «helping people save their way out of poverty can be much cheaper and less risky than helping people borrow their way out of poverty» (Karlan 2010, p. 53). This is because some of the major awkward traits of the poor people are related to behavioral patterns of time inconsistency, hyperbolic discounting, lack of self-control and limited attention problems, which all harm their capacity to save and consume in the future (Loewenstein and Thaler 1989; Akerlof 1991; Karlan *et al.* 2011). A microfinance organization which is successful in mobilizing savings of their members possesses internally all that is needed for working. Compulsory savings in small installments gives members the double potential status of depositors and borrowers, solving their behavioral problems of intertemporal consumption smoothing and providing full insurance for the bank in case of borrowers' default when loans are fully guaranteed by the aggregate amount of the group's savings/deposits. Hence, the combination of group lending with monthly compulsory saving in small amounts makes the microfinance organization relatively safe. The nexus between microfinance membership and savings (even when saving is not compulsory for members) is confirmed by the empirical research of Matteo Marinangeli and Andrea Presbitero who find support for the idea that one of the most important side effects of microfinance membership is providing education on financial and saving matters. The problem which remains even in organizations where the nexus between financial participation and saving education is strong enough is the availability of sufficient social capital since the borrower may find it difficult to retrieve groupmates which are willing to guarantee in case of her/his default. Again, in this case the microfinance literature provides further support for the invisible link between richness of the social fabric and the success of financial intermediation. A community rich in relationships has lower informational asymmetries, lower monitoring costs and superior capacity to create groups of borrowers who can access microfinance loans. Relational ties and abundance of trust and trustworthiness therefore become the necessary premise and the social infrastructure for successful microfinance practices.

Another merit of the microfinance literature is that of overcoming the limits of the monodimensional analysis of the lender-borrower relationship based on economic incentives, bringing social and moral norms into the picture. However, analysis of these two additional and fundamental drivers of human action generally focuses on the negative side (that is, on the role of social sanctions as a deterrent for the borrower's delinquent behavior). The paper by Vittoria Cerasi and Lucia Dalla Pellegrina investigates the nexus on the positive side by looking at the relationship between the borrower's investment and solidarity based money transfers from their peers as a form of insurance against bad events. The theoretical framework of their paper acknowledges that solidarity transfers may have ambiguous effects on productive investment: on the one hand, given the information advantages of peers, solidarity transfers can be made contingent to borrower's effort in productive investment; on the other hand, they reduce the marginal utility of future consumption which is the reward for current investment. The empirical findings of the paper, however, document that it is the positive link which prevails.

The three papers included in this special issue clearly indicate that the interest of microfinance goes well beyond the field of finance and development economics as it helps us to improve our understanding of the multidimensionality of human beings (who respond to economic incentives, but also to social and moral norms). More knowledge of this multidimensionality is welcome to overcome reductionist views which limit our understanding of the potential of economic outcomes and human wellbeing.

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