Chapter 2

Literature Review and Theoretical Background

2.1 Grameen Bank Model

The Grameen Model is one of the most well-known model which was initiated by Dr. Mohammad Yunus in Bangladesh. It is setup as a joint-liability model and the groups are formed voluntarily. There has no influence by the MFI staff in regards to the selection of the group members. Groups are formed with five members who must guarantee the repayment of defaulting members. Groups must agree to make the balance if one member fails to meet repayment of her obligation. The Grameen Model uses dynamic incentives and at the same time the borrower is barred from getting future loans if they fail to meet the repayment installments. A future, bigger loan will be approved only if they repaid the loan in time and follow the loan discipline. In addition, if group are not willingness to make a balance of default member, the rest of all members will not approved to get future loan. (Morduch, 1999 and Besley & Coate, 1995). The concept is that members are peers and neighbors know each other well. This model also focuses on women empowerment and targets especially those who would not normally qualify for credit through the banking system: women, the landless and other vulnerable groups (Conroy, 2003).

2.1.1 Contract Theory

Under joint liability, the peer lending group must repay their individual loan, so that all members are assured to get the next loan. Each group must come up with their group's approval, formal and informal contracts that can mitigate the risk of default and that stipulate the repaying the loan is a utility maximizing the outcome for group members. To be able to manage the risk of group lending, there is a monitoring and evaluation method of reducing the risk (Mehr, 1985). Group meetings are a technique of constructing mutual trust between every single member.

By attending the meeting, members will become more familiar with each other and they can help, discuss and give advice to each other not only about the repayment but also about many of their social affair (Adam, 1992). In practice, in the case of YWDP, the laws and methods are guided by the project's policy management method and it is flexible and can change according to the group member issued.

2.1.2 Theory of Gender Stratification

In the development literature, many authors put forth the claim that women are more likely than men to be interested in family affairs and keep them as first priority. Moreover, they are more likely to use the credit for their business if the business will benefit their family in the long run. (Haing Muir, 1996). In this case, women are more likely to take care of the family affairs such as health care and the children's education. Generally, in most of the poor families, men focus less on taking care of family affairs when compared to women. They tend to use money on themselves for instance, consuming alcohol and cigarettes with friends. When women gain more economic power, it frequently affects the family's well being. Thus, many development funds have been provided MFIs to empower women by helping them to borrow small loans so that those women have opportunity to contribute to the family needs and have the authority of family management.

2.1.3 Peer-group Pressure

Peer group pressure has been known to be very effective in formal business in the developed world. It uses peer control in the group and has found it to be very effective compared to control by supervisor. In the MFI group scheme, group members are neighbors and they can easily notice what the neighbor is doing and report to the other group members if their neighbor is exhibiting or considering risk behaviors. Then the members can consult and resist before the member does takes the risk. Additionally, the local culture can influence in their community and the individual will respect social cohesion and the economic commitments of what they will do after getting the loan.

Moreover, women are easier to control over each other rather than men. Women have more potential to stay around the home and it is easier to monitor and put pressure on them. But there may be a question that the stronger the peer pressure among the group, the corruption will emerge in the group. This is because some of dominant members who have power possess wealth or other skill can be influential and may have their personal preference members.

2.1.4 Adverse selection

In lending mechanism, adverse selection occurs due to the market imperfection (Morduch & Armendariz, 2005). Furthermore, information asymmetry occurs due to the lack of sufficient information among the client's real investment in the bank. So, the lender who sets up the loan with high interest rates to compensate for the risk of not knowing who will create risky projects and who will be a safe borrower. It can implicitly be assumed that the investor will avoid borrowing the loan with high interest rate. But because the profit will go to the lender. Thus, high interest will drive the safer investor out from the credit market and the most unsafe investor will be left as a risky borrower. Despite the fact that the high interest rate cannot earn the profit from the business, those risky borrowers will not gain repaying the loan to lender. It can also be assumed that those borrowers are not expected to deal with the lender for the long run (Berglind, 2007, page 11).

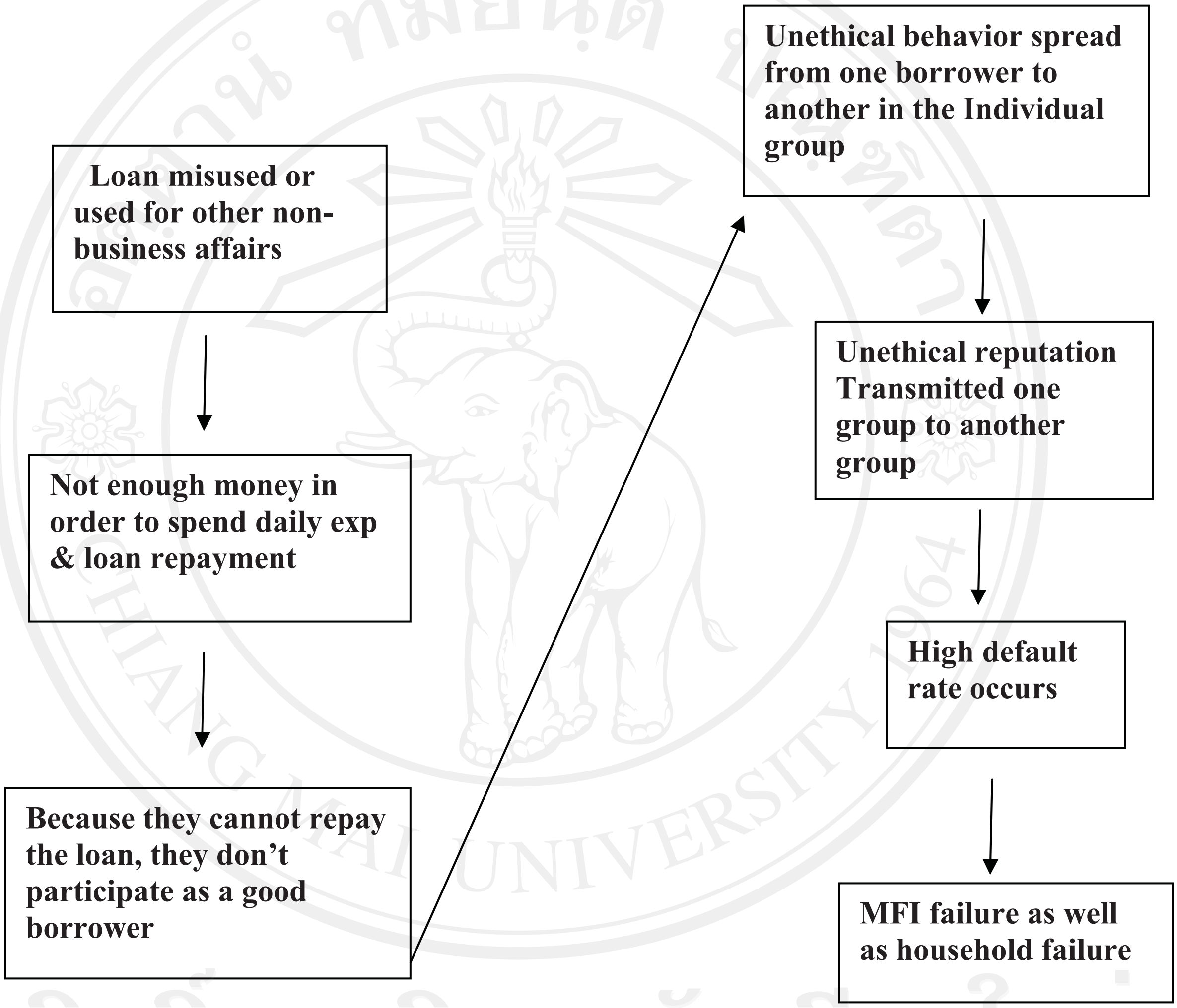
2.1.5 The Role of the Group Leader

The group leader is selected by the group members. The role of the leader is as an intermediary between the group members and the loan officer. Group leaders or treasurers are not offered any stipend or salary; they carry out their obligation as voluntary activities. The group leader mainly supervises the group members, reports on updated group issues of absent members and new members, reminds others of the due date of loan repayment; follows up with member business; checks with loan officers; collects the money with treasurer and hands it over to loan officer.

If a group member fails the repayment, the group leader arranges all the rest of members to make the balance equal so that loan officer can proceed with her activity without delay. An active and strong leader arranges the meeting with the group members and encourages them to repay the loan on time. It has been found that when the village leadership took an active role in screening and monitoring loan activity, repayment rates increased (Julia Anne Paxton, 1996).

2.1.6 Risk Behavior of Borrower in Group Lending

Figure 2.1 Risk Behavior of Borrower in Group Lending



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One danger of the micro-credit methodology is that if one member defaults in the group, the entire group may default (Julia Anne Paxton, 1996). In one group in this study's focal organization, it has to have at least 10 members and a maximum of 30 for the loan guarantee: all have responsibility of loan default. In case, that group has one default, the rest of members must cover the arrear. But, if there are two defaulting members, there is no possibility to cover the arrear. As members are poor, it becomes a great financial difficulty for them to pay for two other loans. The rest of the members may avoid attending the meeting since they have a negative attitude about paying for another person's loan. Thus, the default will spread to the whole group.

On the other hand, misusing the loan also resulted in improper repayment among the peer group. Even one person's unethical behavior can spread to the other members. Hence, borrower-run cases can affect one group to another. Unfortunately, if this bias spreads to many of the groups, will be a great threat to credit institution. Unless there is high collection performance, credit institution may not be sustained in the long run. Proper loan utilization by borrower can mitigate the delinquency or loan default of MFIs. Although the borrower who used the loan in the business, who could be affected by unexpected situation. This could in turn, influence some good borrowers to transform into bad borrowers.

2.1.7 Repayment Performance in Group Lending

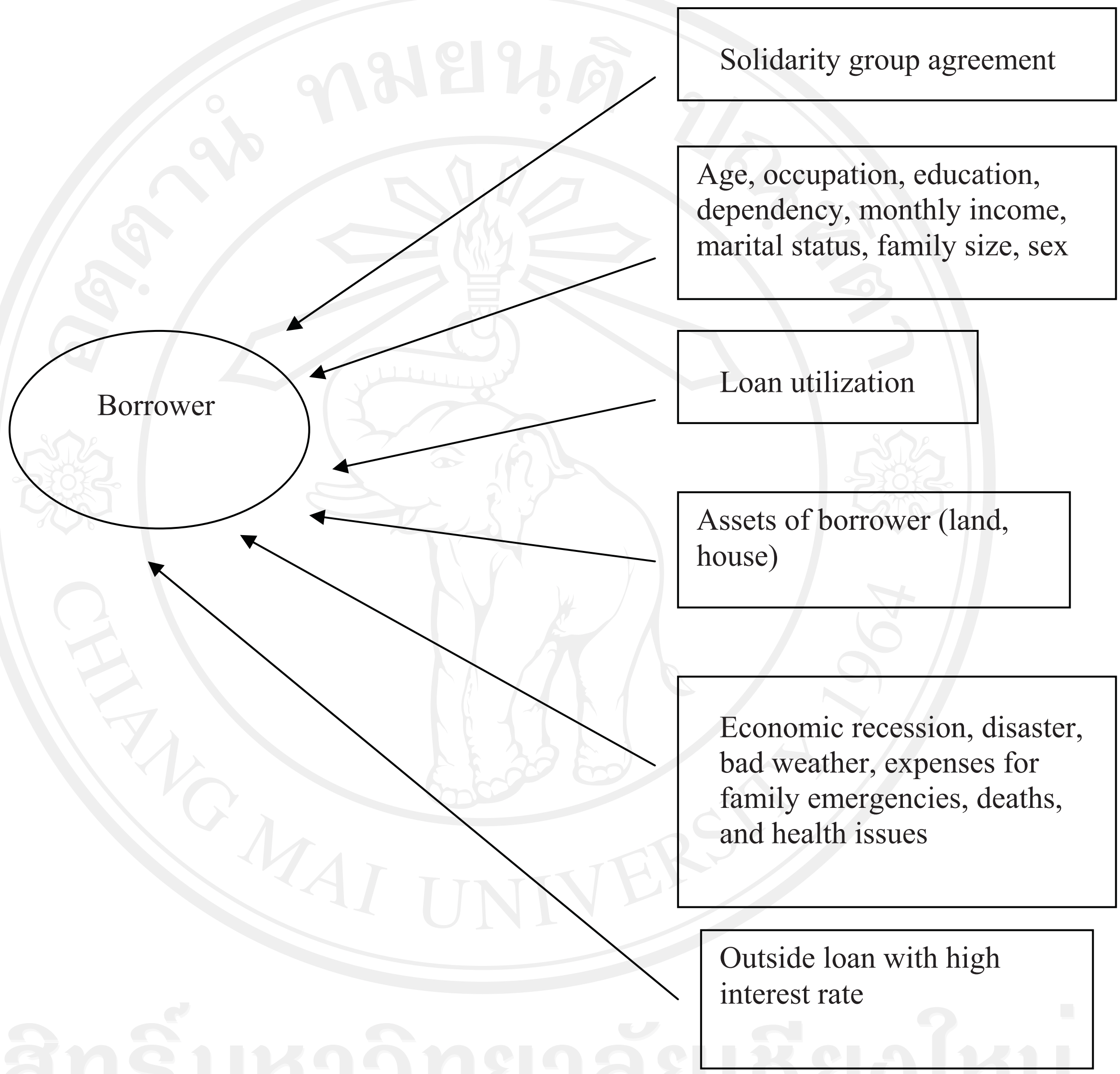
Since, MFIs use the mechanism of loan method is Group Guaranteed Lending and Saving, member are assured to form a solidarity group before they received the loan. According to the contract theory, although group members do not need to pay tangible collateral, they must promise to pay social collateral of group agreement on loan repayment, tried to build up trust on every single member. Being a solid group is the foundation of group lending to prevent the risk behavior of borrower and to share the knowledge and care each other among the member. To be able to form a solid group, normally the assigned loan officer provides a guide line before member get the loan. Basically, loan officer provide the members training. This will affect to maximize the group repayment of MFIs.

Characteristics of borrower will also affect on group lending. It is includes age, occupation, education, dependency, monthly income, marital status, family size, and sex. Differences of borrower characteristics will affect good repayment and bad repayment of MFIs. Depend on the volume of wealth that borrower occupied, there will be affect the good repayment and bad repayment of MFIs. Lending loan always involves uncertain business conditions which created by uncontrollable situations. Uncontrollable factors include economic recession, disaster, and bad weather, expenses for family emergencies, deaths, and health issues. Since, the selected area was affected by cyclone in 2008; it is interesting to know how borrower will face and how they react in that circumstances. On the other hand, Myanmar is heavy rainfall country. During the monsoon season; most of businesses are not doing well. Especially, as for poor family, for instance, street vendor, casual labor and other small business have trouble to earn daily income. So, it can assume that default can occur due to the effect of bad weather.

Despite borrower has one loan from MFIs, some of borrowers had the other loan from local money lender or pawn shop. Traditionally, those commercial lenders have been charging higher interest rate daily or monthly. Since, the country has high inflation, the need of credit from household are quite high. For instance, after borrower received the loan from MFIs, they used it for business then at the middle of year, they do not have investment due to the high cost of commodity, unexpected emergency expenditure, as funeral or wedding of family case, health problem, and education fees of children and so forth. Beside, those borrows will go to money lender to get the loan to be able to solve the unexpected emergency expenditure. Those money lender use to get their debt after borrower get the loan from MFIs. In this way, money lender gain in dealing with borrower from MFIs. In every single ward, there are at least two groups from MFIs. Local money lenders are interested to lend the loan to those clients of MFIs. They may be considering that those borrowers have a potential to get their debt because they are the member of MFIs.

To reduce the risk and improve the welfare of the community, most credit institutions provide small loans with fair interest rates based on a group guarantee. The borrower, who borrows the loan from the MFI, has to guarantee for repayment of other group members in the group. More or less, group guarantee is affected by unreliable behavior of other members. To observe the concept of repayment performance, firstly the credit is provided to the household by the microfinance institution has been using the MFI's specific methodology and loan mechanisms. All project activities and characteristics were guided by methodology, so that lending risk will be minimized.

Figure 2.2: Conceptual Framework of Loan Repayment



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2.2 Literature Review

2.2.1 Group Members' Characteristics

In the analysis of Moh'd Hasan. Al.Azzam (2006) found out that a greater degree of pressure among group member's reduced the number of days of late repayment. Then, Ahlin and Townsend (2005) and Wydick (1999) found out that the cooperation among the group has a positive association that a greater degree of cooperation among blood-relation group members increases the probability of delinquency. This cooperation would be increased if the group has higher proportion of relative members. Wydick (1999) analyzed if the group has monitoring, social ties, and group pressure on the provision of intra-group insurance, reduce the unethical behavior among the group for repayment.

In the analysis of Sharma and Zeller (1996), they also found that social ties, which measured the proportion of relative members in the group, have a negative impact on repayment performance and affected the difficulties of imposing sanctions on relatives, which makes weaker enforcement processes among the members. It is clear that the higher percentage of relatives in the group worsens repayment rates.

2.2.2 Institutional Characteristics

Bekele et.al. (2003) used a logistic regression model to analyze the factors affecting the loan repayment performance in Ethiopia. He used 30 borrowers in Oromia and Amhara national regional states and found out that individuals who took larger loans had better repayment performance than those who took smaller loans. But, Sharma and Zeller (1996) found out that repayment rates are negatively associated with larger loan sizes.

Retta 2000 analyze in Women Fuel Wood Carriers (WFCs) in Addis Ababa, Ethiopia, found that the frequency of the loan (repeat loan), supervision and the suitability of repayment installment periods and other income sources are found to increase the repayment rates and reduced the probability of loan default. Then, Teferi (2002) studied the Debit Credit and Saving Institution (DECSI), and found out that a credit scheme has made its own positive contribution to the borrower's income, access to educational facilities, medical facilities and household diet and savings.

2.2.3 Characteristics of the Borrower

Educational background is one of the significant factors related to borrowerrepayment performance. Literate borrowers are likely to use the loan effectively for the particular purpose. The study of Ahlin and Townsend (2005) found that more productive groups, in terms of education, have better repayment performance. But, Zeller (1998) found that using literacy as a measure of human capital that the coefficient of literacy is not statistically different from zero. Again, Godquin (2002) found out that in the whole sample, education in effect worsens repayment. This explanation exists in the fact that highly educated group have lower repayment performance. In Addis Ababa, Ethiopia, Berhanu (1999) used probit model found that education is negatively related to the proportion of loan. In the " Essays on Group Lending Evidence from Jordan" in which Moh'd Hasan Al- Azan (2006) found out that if the group has higher education then it decreases their credit demand and makes them less concerned about the future larger loans so they give less effort to improve the repayment performance.

The wealth of borrower has high tendency to increase the repayment rate significantly. Bekele et al. (2003) found out that famers who owned more livestock were able to repay their loans even when their crops failed due to natural disaster. Yet, Vigano, (1993) and Yaqub, (1995) found a negative relationship between assets and repayment performance. Another finding of Moh'd hasan Al-Azam (2006) found out that the size of land owned by a group is negatively insignificant. Although, assets ownership improves the role of repayment performance on time, his finding is statically insignificant in the model. In the case of Bahir Dar, Ethiopia, the researcher Mengistu (1997) found out that loan expectation and number of workers employed has a positive relation with full repayment then, his additional findings are loan size, loan diversion and availability of other sources of loan had a negative relationship. Regarding the availability of outside borrowing options on repayment rate, Moh'd Hasan Al-Azam (2006) found out that outside borrowing options will greater incentive for risky project. Abreham (2002) analysis identified that before the loan, having other source of income, education, work experience in related economic activity are increase the repayment while use of loan, being a male borrower decrease the repayment performance.