Chapter 15

Joint Liability Lending, Entrepreneurial Development, and Poverty Reduction

Christopher Boachie
Central University College, Ghana

ABSTRACT

The purpose of this chapter is to examine the effect of joint liability lending on micro businesses in Madina municipality. Joint liability lending has become a popular and fashionable word in financial and development circles. It is a cross-sectional survey study and used both primary and secondary data on joint liability lending. The study reveals that joint liability lending improves entrepreneurship and reduces poverty. There exist a significant relationship between joint liability lending and a high repayment rate. The implications are that individuals within the group are encouraged to continue saving and microfinance institutions should continue investing in educating and training clients to improve upon their micro businesses.

1. INTRODUCTION

Microfinance institutions have played a fundamental role delivering broader access to financial services such as credit, savings and insurance to the poor; however, it is still unclear what policies allow microfinance institutions to successfully offer these services and whether or not the success of such policies depends on the socioeconomic environment in which the institution operates. Group liability claims to improve repayment rates and lower transaction costs when lending to the poor by providing incentives for peers to screen, monitor and enforce each other’s loans. However, some argue that group liability creates excessive pressure and discourages good clients from borrowing, jeopardizing both growth and sustainability. Therefore, it remains unclear whether group liability improves the borrowers overall economic situation and the poor’s access to financial markets. The purpose of this chapter therefore is to investigate whether joint liability lending can lead to entrepreneurial development and thereby reduce poverty.

DOI: 10.4018/978-1-5225-0097-1.ch015
The vast majority of studies in the microfinance literature have focused on the mechanisms behind the success of the group lending model that is used by the Grameen Bank in Bangladesh and by many other microfinance institutions around the world. On the theoretical side researchers have studied how joint liability contracts help to overcome the problems of adverse selection (Armendariz de Aghion & Gollier 2000), moral hazard (Stiglitz 1990; Varian 1990), and enforcement (Besley and Coate 1995). Some theories view the existing level of social capital as critical to the performance of group lending, and state that joint liability contracts can improve repayment because borrowers have better information about each other’s type; can more easily monitor each other’s investment; and can make use of social sanctions to force people to pay back a loan. Other theories contend that joint liability lending may succeed whether or not the contract is implemented among borrowers with high levels of social capital. Empirical studies show mixed results. Some of them provide evidence that social pressure or social cohesion are positively associated to the group performance (Wenner 1995; Abbink et al. 2006; Karlan 2001); while others show that strong social ties within borrowing groups make it more difficult to pressure members to repay loans (Wydick 1999; Ahlin and Townsend 2007). The effectiveness of microcredit as a tool to combat poverty is much debated now that, after years of rapid growth, microfinance institutions (MFIs) in various countries are struggling with client over-indebtedness and repayment problems. This chapter seeks to review and assess the role of joint liability lending in improving social entrepreneurship by focusing on the level of income, loan repayment and savings habits of beneficiaries of Joint Liability Lending.

Under joint liability lending, small groups of borrowers are responsible for the repayment of each other’s loans. All group members are treated as being in default when at least one of them does not repay and all members are denied subsequent loans. Because co-borrowers act as guarantors they screen and monitor each other and in so doing reduce agency problems between the MFI and its borrowers. A potential downside to joint-liability lending is that it often involves frequent and time-consuming repayment meetings and exerts strong social pressure, making it potentially onerous for borrowers. This is one of the main reasons why MFIs have started to move from joint to individual lending. The remainder of the chapter is organised as follows: section 2 reviews the literature on joint liability lending and a description of joint liability loans. Section 3 presents the relationship between joint liability lending and poverty reduction with empirical evidence. Then, section 4 presents strengths and weaknesses of joint liability lending and finally concludes.

2. BACKGROUND

Over the last forty years, microfinance has evolved from the provision of small, agricultural loans disseminated to impoverished farmers in rural areas to include services in urban centers administered to a wide range of households. These institutions now offer services beyond microcredit and operate within diverse organizational structures and institutional environments. Scholars debate the impact of this organizational metamorphosis in terms of the outcomes of the institution and the sustainability of this form of development aid. It seems that microfinance institutions intend to fulfill mission directed outcomes but are coming under pressure to become sustainable financial institutions. The mission of the organization, in theory, determines the target market served and guides the provision of services, in terms of outputs, to specific types of clients. In this piece, this distinction will be framed in terms of a welfarist versus institutionalist philosophy of lending, each with a focus on a particular clientele, desired outcome, and attained by particular administration of services.