Effects of Peer Monitoring and Contract Choice on Repayment Rates Under Group Liability Lending: A Laboratory Microfinance Experiment From Australia

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ABSTRACT

This article addresses the issue of peer monitoring and choice of contracts on the repayment behaviour of the subjects. The authors conducted a laboratory experiment using student subjects from the University of Sydney, Australia by employing profit sharing (PS) and conventional interest based (IB) microfinance contracts. In the four treatments, subjects were given the choice to monitor their group partner and also had the choice between selecting one of these two contracts under the group lending scenario. The results indicated statistically significant effect of monitoring on the repayment rates. Interestingly, a significantly high percentage of subjects opted for the PS contracts against the IB contracts. These higher take up rates of PS contracts, however, were not associated with an increase in repayment rates. Not surprisingly though, as the experiment was conducted in Australia, the level of religiosity remained rather an insignificant factor affecting the repayment behaviour of the subjects.

KEYWORDS

Asymmetric Information, Group Lending, Interest, Laboratory Experiments, Microfinance, Peer Monitoring, Profit Sharing

1. INTRODUCTION AND MOTIVATION

The lack of sufficient income generating resources lead to lower levels of household income which in turn can explain the high incidence of poverty that characterize many of the third world nations. In recent times, microfinance has emerged as one of the most potent instruments to address and alleviate this problem. The access to microfinance has allowed a large number of individuals to enter the credit market; individuals who do not have access to the formal credit market because of their lack of collateral. These microfinance loans are generally provided for the formation of new small businesses or expansion of existing businesses so that the income generating capacity of the poor may be increased. Dr. Muhammad Yunus, who received the Nobel Prize in 2006 and is the founder of Grameen Bank, stressed that the basic principle of microfinance is to help such collateral constrained individuals to achieve self-sufficiency (Sharma, 2001). However, it must be noted that in spite of the increasing popularity of microfinance programs in the last three decades, 2.7 billion (72 percent) of the people in the developing countries are yet to gain access to formal banking (Kendall, Mylenko and Ponce, 2010).
It is important to note here that almost all the microfinance programs (like Grameen Bank in Bangladesh, Khushali Bank in Pakistan, etc.) use traditional banking practices in which the borrowers are required to pay interest on their loan obligations. It is of interest to note that although nearly 44 percent of the microfinance clients around the world are from the Muslim countries, even today, almost 72 percent of the Muslims do not participate in these microfinance programs because the repayment of loans demand interest payments (Honohan, 2008; Karim, Tarazi and Reille, 2008). Thus, to a large extent, the conventional microfinance programs have not been able to reach all its potential customers. Moreover, casual empiricism suggests that many borrowers who are currently utilizing the conventional microfinance products might switch to non-interest-based microfinance products if and when they are available. Indeed, because of such sentiments, a number of Islamic Microfinance Institutions (IMFIs) have emerged in recent years offering various non-interest-bearing products, but the progress and growth of these institutions is far below comparable to the conventional MFIs (Dusuki, 2008).

In the last twenty years, a considerable part of literature studying conventional microfinance programs has evolved (Ghatak, 1999; Ghatak and Guinnane, 1999; Giné and Karlan, 2014; Morduch, 1999; Varian, 1990; Wydick, 1999). In contrast to that, the literature on Islamic microfinance is somewhat limited, such as Hassan and Ashraf (2010), Karim, Tarazi and Reille (2008), Khan (2008), Obaidullah, and Khan (2008) and Yousfi (2012). However, very few of them have studied the comparative efficacies of these two different systems in an economy with Muslim-dominated population. A notable exception, however, is a paper by (El-Komi and Croson, 2013) which investigates the comparative performance of the conventional (interest based) and Islamic (non-interest based) microfinance programs. In particular, they compared two non-interest-based contracts (Profit Sharing-PS and Joint Venture-JV) with the conventional interest based (IB) contracts using a set of laboratory experiments. They found that PS and JV contracts outperformed the IB contract in terms of repayment rates. Traditionally, the Profit Sharing (PS) contracts are more prone to enterprise failure, adverse selection, moral hazard and costly verification due to asymmetric information (El-Gamal, M., 1997). Hence, the use of PS contracts has been minimized in Islamic Banking practices. To overcome the problem of moral hazard and costly state verification the effective tool of peer monitoring is widely adopted (Cornee and Masclet, 2013). On the other hand, it has been argued that there has been risk pooling between borrower and lender in PS contracts due to its sharecropping phenomenon resulting in generating different power structure among both the borrowers and lenders. Thus, PS contracts are considered as more equitable than IB contacts and creating a strong obligation for the borrower to comply with the terms of the contract to repay the loan in case of project success (El-Komi and Croson, 2013).

Microfinance institutions (MFIs) normally use group lending in which members are jointly held responsible for the repayment of the entire loan. It has been argued that the use of joint liability contracts allows self-selection of the borrowers as each borrower has an incentive to join the group with safer borrowers. This thus saves on the ex-ante “screening costs” of the lender to identify the safe borrowers (Ghatak, 1999; Tassel, 1999). A related argument (Ahlin and Townsend, 2007; Armendariz and Morduch, 2005) rely on the use of “peer monitoring” to explain the use of joint liability contracts. Under such a contract, each member in the group has an incentive to monitor the actions of the other members to ensure a proper utilization of the borrowed funds. This thus plays an effective role in enforcing the conditions of loan repayments and helps the lender save on the monitoring costs associated with the ex-post moral hazard problems. Social ties among the borrowers and the possible use of social sanction against defaulting borrowers can also justify why group liability contracts may dominate individual lending contracts (Abbink, Irlenbusch and Renner, 2006; Besley and Coate, 1995; Chowdhury, Chowdhury and Sengupta, 2014).

In recent years, the effects of peer monitoring on repayment behaviour have also been investigated in the laboratory as well as in the field experiments (Cason, Gangadharan and Maitra, 2012; Kono, 2006). Similar studies have also looked at peer monitoring and the choice of individual and group
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