What lessons can European history offer for modern microfinance institutions?

Timothy W. Guinnane
Yale University

Micro-finance today

- Very widespread, mostly based on new institutions formed in the 1970s and 1980s
- Often used what are viewed as novel approaches to lending:
  - Target women as better borrowers (and most in need)
  - Joint liability (JL) lending to ensure repayment
- Original focus on lending, some now adding savings and payment services

Has it worked?

- Hard for anything to live up to all this hype (since when do economists get Nobel Peace Prizes?)

- Successes
  - Lots of loans made
  - Some groups of people (such as women) have credit for the first time

- Disappointments
  - Costs very high in many cases, often requiring implicit or explicit subsidies to continue
  - Cost/benefit studies disagree on this use of funds for donors
    - Many competing ends – disease eradication, for example
    - Some studies suggest small grants better than actual lending

Is it new?

- No: long tradition of specialized institutions to provide financial services to poor people
- What's different now is where (which countries) and to whom (what kind of people)
- Problem with ignoring the past:
  - Lessons in earlier experience that are relevant today
  - Some institutional models dismissed today for no particular reason

Why do we need specialist institutions (What's different about lending to poor people?)

- Basic problem of lending is information
  - Lending only to careful borrowers (screening)
  - Making sure the borrower is careful with the loan (monitoring)
  - Seizing the borrower's assets if he does not repay

- Three ways to contend with the information problems
  - Require collateral security (by risking his assets, borrower has an incentive to behave)
  - Require co-signer who has assets or is known to the lender
  - Know borrowers really, really well

Problem: poor people are *poor*

- Collateral
  - Poor people by definition do not have significant assets
  - What they do have (for example, household goods) requires a specialized lender if those assets are to be used as collateral for loans (see below)
- Co-signers
  - Poor people's friends and relatives are mostly poor, and thus not of interest as security
  - (In some cases, wealthier people act as co-signers, but at a cost that increases borrowing costs)

Other problems

- Information is the main problem: poor people do not fit well with conventional lending tools

- But other ways poor people might be different:
  - They might be illiterate
  - They might move around a lot
  - Their may be other social/cultural barriers that affect their credit-worthiness (such as women)
  - Their low incomes mean that small "shocks" can make it impossible for them to service loans

Three "microfinance" institutions in 19th-century Europe

- Credit cooperatives
- Savings banks (Sparkassen)
  - Broad mandate to provide safe savings services; microfinance only on liabilities side
  - Helped to fund city and other government debt, in addition to private loans
- Pawnshops (Pfandleihe or Leihhaus)
  - Loans on collateral consisting of household objects
  - Often but not always funded by savings banks

Three possible lessons for microfinance today

- Few microfinance institutions today are credit cooperatives. Why?

- Microfinance groups slow to reach out to savers. Can do better.

- Microfinance takes very dim view of pawn lending. Why?

Credit cooperatives

- Credit cooperatives and modern microfinance
  - Robust in some places, such as French-speaking Africa
  - Raiffeisen organization, World Council of Credit Unions, other organizations try to help
  - But credit cooperatives still unusual relatively to role in European history

- German credit cooperatives in the 19^{th} and early 20^{th} century self-sustaining; State financial assistance modest, Schulze-Delitzsch cooperatives accepted no State assistance

- Why?
  - Unsuccessful history of cooperatives established in colonial period
  - Sometimes corrupt or tools for government assistance
  - Natural to want to “start fresh” with something new

Advantages of credit cooperatives for microfinance

- Much of the thought in modern microfinance goes into ways to lend to the right people and get them to repay
- Same for credit cooperatives: why re-invent the wheel?
- Credit cooperatives borrow from some local people and lend to others
  - Thus naturally provides both lending and savings services
  - Expands the range of interested people to include savers

Group lending

- Grameen and others “pioneered” group lending to overcome information problems
  - Individual borrows, but broader group providers security for the loan
  - Thus the group screens (keeps out bad borrowers) and monitors (encourages behavior likely to allow repayment) and backs-up loan if borrower defaults

- Group lending not really new
  - Schmidt borrows, Mayer co-signs the loan
  - Basic tool of lending for centuries

- Group lending with cooperatives
  - German credit cooperatives lent heavily on co-signatories
  - But the cooperative is a second group: collectively liable to cooperative’s debts

Savings banks

- Basic design of a European savings bank: accept deposits that are guaranteed by some State entity – thus safe
- Reasons for savings banks
  - Obtain finance for state purposes, other borrowers
  - Formal savings accounts when many ordinary banks did not accept retail deposits
  - Effort to promote regular savings among the poor
- Not unknown in developing countries today, but rare compared to European past.
- Unclear why this basic design not part of the microfinance movement today
  - Could be invested directly in some safe asset, such as ~~Greek~~ German bonds
  - Might be used in part to finance local government debt
  - Could fund other lending – such as pawnshops

Pawn lending

- How it works
  - Lending takes and holds object that is security for loan
  - Thus has to be objects that are
    - Easy to move (not the house)
    - Of value
    - Easy to store (not grain or horses)
    - Borrower can do without (not only set of clothing)
  - High interest rates in some contexts
    - Lending costs high, because need to store objects
    - Might also have local monopoly power
  - Only "inexpensive" where subsidized
- Why pawn lending works
  - Only information problem is value of object
    - If loan/value ratio low enough, pawnbroker safe
    - No need to have information on borrower
  - All but the very poorest households have assets that can be pawned
    - Jewelry
    - Clothing for special/festival occasions
    - Tools and equipment out of season

Advantages of pawn lending

- Poor people have *some* assets
  - Expertise for pawn lending is different than for conventional lending
  - This implies need for a specialist lender to lend on the basis of this type of security

- "Remedial" pawnbrokers can reduce monopoly power, thus improving conditions for all
  - Long tradition of Mont-de-piété and similar lenders in Europe
  - Often connected to savings bank; funding for loans comes from the savings bank
  - US has not-for-profit pawn lenders even today

- Pawn interest rates often very high, but no higher than the *true* cost of lending on Grameen model (for example)

In sum: long history of microfinance

- Microfinance today can take credit for successes, but has fallen short of its goals in some circumstances
- Historical experience of microfinance ignored by most practitioners and scholars
- But three models that worked well in Europe, and offer well thought-out models for microfinance today
  - The credit cooperative: widespread, successful lending to borrowers not suitable for banks
  - Savings banks: guaranteed savings services for all
  - Pawn lending: perhaps limited scope, but suitable for at least some hard-to-reach clients
- Yes, context different today than in Westphalia in the 19th century. But the core problem of lending to poor people has not changed.