The advantages and disadvantages of group lending and its solutions

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ABSTRACT

As one of the most innovative methods of microfinance, group lending has already taken a significant part in poverty alleviation across the world, especially in India, the place where it was first adopted. The essence of group lending is the joint responsibility. Compared with the normal loans, its innate mechanisms are rather helpful to solve the problems of adverse selection and moral hazard. Also, group lending can increase the income of farmers indirectly and enhance the status of women. However, with the rapid development of group lending, more and more problems are emerging. In China, group lending is more like a short-term policy controlled by government only. In this paper, a thorough research on the foregoing papers would be presented. The establishment of insurance system and the clear role played by government are crucial in solving the issue of poverty in rural areas and to make ensure the sustainability of group lending in China.

Key words: Group lending, three dimensional rural issues, poverty alleviation.

INTRODUCTION

Trying to finance the poor in the rural areas in Bengal, Muhammad Yunus began to make loans to the farm households and founded the first bank, Grameen Bank, to support the poor. At first, Pro Yunus gave 27 dollars to a poor woman (most of his debtors were women, constituting 96% of 4 million debtors). Later the branches of Greeman Bank covered 46,620 villages and the staffs were more than 10 thousand. To everyone’s surprise, the credibility of debtors was rather high (the repayment-performance rate was up to 98.89%) and the bank made profits for consecutive 9 years, successfully helping 4 million poor people to get rid of poverty. The mode of GB was copied and published across the world since it not only helped the poor but also achieved the sustainable development, breaking the Matthew Effect, namely that the rich are always rich while the poor stay poor. On October, 13th 2006, the Noble Prize Awards announced that the Pro Yunus was rewarded the Peace Prize for his efforts to the economic and social development.

James Wolfensohn, the former president of World Bank, said that the Micro Credit programme brought great shock of market economy to the poorest villages and people. This effective measure helps the disadvantaged to eliminate poverty with dignity through their efforts. Micro credit is continuously changing the living condition, psychology, and expectations of the future of people in the richest and poorest countries across the world. Up till now, micro-finance still provides the constant finance credit services, substantial financial system in some countries and religions. Large amount of evidence showed that the microfinance has played the increasingly important role in financial areas and economic development in rural areas.

The mode of Self Help Group-bank linkage has developed rapidly and has satisfied the credit needs of farm households basically (Wu and Gao, 2009). SHG is the typical mode of group lending on the basis of joint responsibility. Up to March, 2012, there have been more than two million groups and thirty five million members across India, helping nearly one hundred and thirty million people. The amount of loan of SHG is up to one hundred and ninety nine billion roubles. The rate of non-performing loan is 3.5%. The group lending is playing...
an increasingly important role in poverty alleviation in rural areas in India.

Since group lending has played such an important role across the world, group lending is a main topic in many articles.

**Microfinance in rural areas**

To the farmers in rural areas, one of the most severe problems to make a decent living is the lack of capital. To make things worse, without sufficient properties, they are also facing the difficulty of getting a loan or finding a guarantor. In this way, microfinance is seen as prescription for their poverty problem.

Microfinance is a significant source of financial service for entrepreneurs and small businesses, both of them lacking access to banking and related services. In rural areas, microfinance is a movement whose goal is ‘a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance and fund transfers’. The basic characteristics of microfinance are small amount of loan, serving for the poor and no guarantee or mortgage. The most important ways of microfinance in rural areas are:

**Focusing on women**

Compared with making loans to men, making loans to women is regarded more beneficial. On one hand, according to the credit history, the repayment performance of women is much better than men, while on the other hand, women who get loans would invest more in children’s education. This practice is not only beneficial to the future of the whole family, but also to economic and social development of the entire country. Therefore, most of the microfinance would choose to focus on women.

**Microenterprises**

In general, a micro-enterprise is considered a small business employing 10 people or less, and having little capital asset. In developing countries, micro-enterprises constitute the vast majority of the small business sector, a result of the relative lack of formal sector jobs available for the poor. Micro-enterprises in developing countries, then, tend to be the most frequent form/size of business. The impact of micro-enterprises is very significant, since they can add value to a country’s economy by creating jobs, enhancing income, strengthening purchasing power, lowering costs and adding business convenience. However, micro-enterprises typically have little or no access to the commercial banking sector, therefore, they often rely on the microfinance. Microfinance institutions often finance these small loans, particularly in the Third World.

**Rural customers**

Formal credit and savings institutions for the poor have also been around for decades, providing customers who were traditionally neglected by commercial banks, a way to obtain financial services through cooperatives and development finance institutions. One of the earliest and longest-lived micro credit organization providing small loans to rural poor with no collateral was the Irish Loan Fund system initiated in the early 1700s by the author and nationalistic Jonathan Swift. Swift’s idea began slowly but by the 1840s and had become a widespread institution of about 300 funds all over Ireland. Now, rural customers have become an indispensible part in microfinance.

**Non-financial service**

Apart from the traditional financial service, microfinance also provides non-financial service. In order to provide the best and overall service, non-finance is significant since some customers may have some non-finance demand.

**Group lending**

With the aim of obtaining loans from a lender, group lending refers specifically to arrangements by individuals without collateral who get together and form groups. The special feature is that the loans are made individually to group members, but all in the group shoulder consequences if any member runs into severe repayment difficulties (Beatriz and Jonathan, 2005). In the Grameen Bank case, the most typical mode of group lending are the groups made up of five individuals.

Indicated by its name, group lending is to lend as a group, instead of individuals in normal loans. However, the members of the group are not chosen randomly. Generally, group lending satisfies the following conditions:

1. The individual member cannot provide mortgage or guarantee;
2. The potential members can get the relative information of other members at low costs;
3. The groups are well-organized and are facing social pressure.

The most typical mode of group lending is: let’s assume there are five people in the group. First, two of them would get loan. Four to six weeks later, another two members would be loaned only when the former two repay timely. After another four to six weeks, the leader of the group would get his loan finally (Beatriz and Jonathan, 2000). Once any member does not repay timely, the next loan
would be delayed. But if there is no problem of the repayment, the amount of the next loan would be larger, allowing the other members to invest more. The key point of the group lending is that the repayment-rate performance of one member would affect all other group members. If one of the members does not repay promptly, the other members would get punishment as well. Therefore, the group, as a whole, is seen as one subject to shoulder the responsibility of lending. The group lending is the main topic of microfinance in this article.

The operation of group lending

The essence of group lending is the joint responsibility, a systematic innovation of traditional credit way between financial institutions and individual farmers. The group lending has many unique operational mechanisms, that is, peer selection mechanism, two-way supervision mechanism, guarantee replacement mechanism, repayment symbiosis mechanism and multi-win-win mechanism to ensure the smooth operation (Kong et al., 2010).

Peer selection mechanism

This mechanism relies on the fact that the debtors who are familiar with each other and have the similar risk make up one group voluntarily. In this way, they can eliminate the possibility of including the potential debtors with higher risk. The standard financial institutions make loan and ensure the repayment in time on the basis of filtering their clients. Filtering the clients is the first and the most important step in the standard process of making loans. The traditional way of filtering the clients is to gather their information and ask them to provide mortgage or guarantee. However, most of the poor farmer households cannot provide the mortgage or guarantee and they lack relative credit history. At the same time, the cost of financial institutions to gather their information is rather high. Therefore, the traditional credit way cannot filter the farmer clients automatically. However, the group lending can correct this problem. This method can filter the clients who have the credit demand, good ability to repay and good credit and match automatically. Finally, the appropriate debtors can be well selected in one group. The realization of peer selection mechanism is dependent on loan interest rate set by the financial institutions and the joint responsibility of group members.

On the one hand, the interest rate of group lending is higher than the traditional loans, resulting that most of the rich farmers who have the property to mortgage give up the group lending because of the higher rate. This mechanism ensures to sort out the suitable debtors. On the other hand, the members in the same group assume the joint responsibility, namely, that if one of the members cannot repay timely, the other members have the obligation to pay for him/her. According to the hypothesis of rational person, the debtors who have lower risk are not willing to compensate for higher risk, if they expect to maximize their expected return. However, in the group loan, they are required to pay for the loan because of the joint responsibility and increase their cost of loans, so they would be inclined to choose the farmers who share the close risk of loans. Since the members of the group lending are from the same country, they are quite familiar with the income and credibility of each other. In this way, they can exclude those who have bad credibility and may not pay for the loans. Therefore, this mechanism can select those who have better credibility automatically.

In conclusion, through the peer selection mechanism, the farmers can make best use of the information among them in rural areas and the risk of individual loans can be transferred from the financial institutions to the poor farmers who are in need of the loans and share the risk voluntarily. This mechanism can relieve the adverse selection resulted from the hidden information and decrease the high transaction cost. Meanwhile, the peer selection mechanism can also be helpful in increasing the repayment performance rate, welfare and the efficiency of financial credit market.

Two-way supervision mechanism

The group lending includes the internal and external monitor. The supervision among all the members in one group plays the major part in the internal monitor. The members in one group live in the same or near countries, so they are familiar with the characters, living habits, incomes and reputations of each other. Before applying the loan, every member would provide the detailed and authentic information of other members to the working staff; when some members get the loan, the others would take advantage of the relatively transparent information and know the usage of the fund, the progress of project, the current return and the prospects of their investments. Later, the farmers would feedback the information to the working staff through the central meetings and other possible ways. This is the mechanism of the inner monitor. In the meantime, the microfinance institutions would also conduct the external monitor with the relative department in local government and the neighbourhood committee members by holding the meetings to inspect the loan project.

Grameen Bank’s weekly group meetings have some obvious and simple advantages for the lender and debtors. They offer convenience to the villagers immediately: the bank comes to them and any problems (for example, a missing document) can be resolved on the spot. At the same time, transaction costs are greatly reduced for the loan officer since the multiple savings and loan transactions can take place in a short block of time.
Guarantee replacement mechanism

This mechanism refers that in the group lending, the social assets, namely high reputation with great value and social network, etc., owned by poor households, substitute the traditional collateral which the farmers are not able to provide in the traditional lending. In fact, the majority of farmers are lack of the collateral recognized by the formal financial institutions. According to the surveys, the poor are rich in reputation, but not fund and they are more willing to pay for the loan than the rich in some cases. However, if the poor want to obtain the loans from the formal financial institutions, they have to show convincing evidence to prove their willingness and ability to repay. While the guarantee replacement mechanism is based on the situation that the poor farmers are rich in available social resources but lack economic resources; it provides a shortcut for the farm households to show their willingness and ability to repay with non-economic resources. Lacking the physical security, the reputation, social network and other social capital are extremely important asset for farmers living in fixed areas for a long time. Therefore, the punishment used by depriving social asset is much easier and more severe than economic or legal punishment to the farmers. In this way, the guarantee replacement mechanism in group lending not only increases the availability of formal loan to the farm households but also enhances their willingness to repay, decreasing the moral risk.

Repayment symbiosis mechanism

This mechanism is dependent on the rewards and punishments in group lending. On one hand, it is compulsory that all the members in the group lending repay their loans according to the contract. If one of them cannot repay because of the failure of project, all the other members are obliged to pay the loans and interest for him/her since they assume the joint responsibility. If the member of the group lending refuses to repay or repay out of the time limit, he/she would get the bad reputation, lower credibility, less amount of loan and even no loans later.

In addition, if the other members in the same group do not take the joint responsibility or are not willing to repay, they would get the similar punishment as well. On the other hand, if the members are able to repay timely in the process of repayment, they would be allowed the same amount of loan or even larger. As consequence, the whole group would get better reputation and higher credibility in the later loans. However, if one of the members cannot repay after they apply for loans, but other members pay the loans and interest for him/her on time, then the members or even the whole group still gets a good reputation and other possible rewards. This is how the repayment symbiosis mechanism works. This mechanism increases the repayment performance rate and facilitates the continuous loans. On the basis of satisfying the loan demand of the farmer, the microfinance institutions realize the profits and sustainable development.

Multi-win-win mechanism

This mechanism means that the group lending ensures the goods of the farmer, agricultural industry, microfinance institutions, government and the entire society. Through the mutual aid in group lending, the possibility for poor farmers to get formal funds is much higher and the shortage of capital is alleviated. At the same time, in the group lending meetings, the members would select the projects together, share the successful and unsuccessful experience, supervise the project or the usage of funds each other. These meetings would develop their ability to make money and increase the income of farmers. Through group lending, the microfinance institutions explore the financial market in rural areas, make new profits and ensure their sustainable development. Also, the group lending provides a new way to help the poor by transferring funds provision solely to money making, namely that the traditional financial subsidy is transformed into the innovative financial support. This transformation is rather useful to change the root of the current situation of rural areas. Group lending combines the financial support, project guidance, technique cultivation and information provision together, increasing the production of agricultural industry and facilitating the development of agriculture. This combination is an effective measure to solve the root problem of poverty.

THE ADVANTAGES OF GROUP LENDING

Transacting through groups also has more subtle advantages (and some limitations). In particular, the group responsibility clause of contracts can mitigate the moral hazard, adverse selection, and enforcement problems that crippled previous attempts at lending to the poor by outside financial institutions.

The contracts take advantage of the fact that group members themselves may have good information about fellow members – and the contract gives the members incentives to use their information to the bank's advantage.

Mitigating Adverse Selection

It is believed that the group loan can solve the problems of adverse selection. The adverse selection problem happens when lenders cannot distinguish inherently risky borrowers from safe borrowers. If lenders could tell the differences of risk types of borrowers, they could charge
different interest rates to different types of borrowers. Options are limited because of poor information (Beatriz and Jonathan, 2005). Adverse selection may lead to credit problem because it induces lenders to charge everyone high interest rates to compensate for the possibility of having very risky borrowers in the customer population. Trouble and inefficiency arise when safe borrowers are thus deterred from applying for loans. In principle, group lending with joint responsibility can mitigate this inefficiency; the most direct mechanism occurs when customers inform the bank about the reliability of potential joiners, allowing the bank to adjust terms accordingly. The following is the mechanism in detail. As we all know, the bank charges the safe customer lower interest rates while charges of the risky customer is of higher rates. If the bank cannot distinguish them, it will charge the same rate and the safe customer compensates the higher risk. If the rate is too high, the safe customers will pull out of the market (Jiang, 2012). However, in the group lending, the potential debtors will make full use of their information to find the most suitable members. Therefore, the safe customers will find the safe ones and the risky customers can only find the risky ones. The risky customers may have to make other members’ repayment because of the joint responsibility; otherwise, they cannot get a loan in the future. Consequently, the risky customers would take the risk and the banks can lower their interest rates to attract the safe customers and therefore the social welfare increases. We can see that the process of building a group is to explore and reveal the information of the debtors. The local farmers know the relative information far better than the banks or the financial institutions, such as whether a certain farmer has the capability to produce, whether he or she enjoys good reputation and what type of debtor he or she is. This process decreases the operational cost of the microfinance institutions and also the risk of adverse selection.

Overcoming the moral hazard

In the foregoing section we have discussed how group lending with joint responsibility can mitigate the adverse selection at the group formation stage. In this section we showed how group lending with joint responsibility may circumvent moral hazard problems in lending, thereby, further relaxing credit constraints. Here, we are dependent on the possibility that group members who often live and work closely together can impose social or economic sanctions on each other, sanctions that are impossible for an outside bank to impose (Zhang and Chen, 2003). In a group, if you are not willing to repay, the other members will blame you because their loans will be affected negatively. Under heavy peer pressure, the members would repay timely since they are dependent on the community to large extent. Meanwhile, living in the same community with high frequency of daily interactions, the members can help and supervise each other effectively. Also, the staff can gain a timely and accurate command of relative information from these interactions, lowering the hidden moral hazard of the debtors (Liu and Ye, 2002).

Increasing the income of the disadvantaged

The group lending in India lowers the interest of loan, increasing the income of the farmers indirectly. Before the publicity of group lending in India, when the poor farmers were in need of capital in agricultural production, they would turn to the local lenders who always ask for high interest rate. Suffered from the high interest rate, the farmers had no way to solve the poverty problem. Therefore, the lenders were richer while the farmers were poorer. This is a vicious circle. With the promotion of group lending, the reliance of farmers on lenders is less. Though the interest rates of financial institutions engaged in group lending vary, they are far lower than that of local lenders. According to the survey conducted by International Bank of Reconstruction and Development, those farmers who do not participate in group lending need to pay for interest rate up to 18%, while those who do only need to pay for 2.5%. Many farmers are only using the available capital saved by group lending to engage in commercial activities, increasing their income to large extent.

Enhancing female capability and status

It is a tradition in India that the females cannot enjoy equal status in families and the whole society. Since the group lending was promoted, many females in the rural areas have exposed themselves to the outside world and have taken advantage of loan to develop the service industry and agricultural production industry. With better capability to earn money, the females in India can now enjoy higher status than they did before. Some programs of Joint Liable Group are aimed at the female children. They make loans to the females directly with simple application procedure. Group lending can play significant role in enhancing the status of females all over the world.

THE DISADVANTAGES OF GROUP LENDING

By far, the group lending seems like the perfect solutions to problem of poverty in rural areas. Muhammad Yunus, the leader of the Grameen Bank, was even awarded the Nobel Peace Prize for his devotion to the group lending. However, with the deepening and continuous development of group loan, more and more problems are emerging. In India, the place where it was believed the most successful demonstration of group loan, a crisis broke out in 2011. With higher market share of microfinance, the interest rate
increased significantly in India; the rate which was unbearable for the poor farmers. The premier of Bangladesh criticized that the microfinance was to make profits from the poor, instead of helping them.

The reasons of the failures of group loan vary. There are mainly two explanations. Some argued that the corruption of banking systems, the ignorance of high transaction costs and the unsuccessful attraction of getting deposits should take the responsibility of the failures or limited success of group lending, namely; that the system is to blame. The others explained that the specific environment is the account of the failures, such as the poor harvest. The main disadvantages of group lending are the following.

The lack of punishment
Punishment is one of the key issues of the effectiveness of the group loan. But in the rural places where people are too familiar with each other, in cities where people are too unfamiliar and in the places where law enforcement is absent, the punishment is hard to impose (Jiang, 2012). Without effective punishment, the group lending will fail to gain sustainability, which is the foundation of long-term operation of group lending.

The cost of supervision is too high
Group lending is to transfer the responsibility of the banks to the members of groups. But if the members believe that the cost of time and energy to supervise is too high, they would decide to quit. As one of the most innovative practice of microfinance, group lending was initiated because of the lack of sufficient guaranty. The lack of sufficient guaranty results in the warranty from the third party, the warranty by combining the reputation and joint responsibility. Therefore, the individual farmer would obtain the warranty by collaboration. When the return of collaboration outnumbers the cost of collaboration, the farmers who are in need of loans will develop the mode of warranty between households. However, if they believe that the cost outnumbers the return, they have no incentives to join group lending. This problem is more severe in the leaders of groups. The suicide of leaders in Indian group lending is the best illustration. Also, the meetings of groups are one of the important reasons that members quit the groups. Since some of them take more than an hour to the place of meetings and the meetings last over 100 minutes. The meetings for the farmers are too time-consuming (Jiang, 2012).

The lack of incentives
According to the regulation of group loan, the members assume not only their own responsibilities, but also others, so it may bring more risk to the members. If the members are risk-averse, they may be unwilling to shoulder the duty. This poses serious problem to group lending, since if the farmers are not willing to participate in the program, they cannot enjoy the advantages of group lending (Zhou and Li, 2010).

The problem of collusion
The social connection may increase the repayment rate, but can also decrease the rate. If the members have colluded, the adverse selection and moral hazard may still arise (Zhou and Li, 2010). Moreover, if the members decide to collude, they may hide the truth to the staff of group lending. When the institutions find out the problem, they may be too late to get the loan back, causing acute crisis of the sustainability of financial institutions which are engaged in group lending.

Immoral punishment
Sometimes, the punishment of breaking the contract is too severe. For example, if the debtors cannot repay on time because of the natural disasters, then the punishment is immoral (Jiang, 2012). Different from other industries, the agriculture industry is highly dependent on the natural environment, which cannot be affected by human force. Therefore, to punish farmers for poor harvest only is too immoral.

THE DEVELOPMENT OF GROUP LENDING IN CHINA
In China, group lending, as a unique method of rural financial services is supposed not only to help farmers who are in great need of capital to get access to credit for farming operation, but also to help financial institutions to reduce the credit risks and get more profits. The group lending has become one of the keys to solve the three dimensional rural issues with the development of this successful practise of farm households in some areas in China, since the 90s of the last century.

In China, the three dimensional rural issues need to be solved as fast as possible. So far, the dilemma of difficulties of farmers to get loan and the obstacles of financial institutions in rural areas to make loan has caused the shortage of capital in our country, hampering the overall development of rural economy. Affected by the mode of rural banks in Bangladesh, we introduced the microfinance officially in the 90s of last century, in order to find out the best mode to support finance in rural areas.

At the beginning of the introduction, we copied the mode of Bangladesh completely. One of the most obvious features is to make loan to a group. The earliest test in China is the Supporting of The Poor Economic Corporation,
CONCLUSION AND SUGGESTIONS

Though group lending is still imperfect and immature, there is no doubt that it has contributed a lot in poverty alleviation and social development. In China, the three dimensional rural issues are urgent and severe. We can learn from the successful experience of group lending and combine the power of different organizations to solve the poverty in rural areas. With more capital, the farmers can enhance their conditions of producing and living. Also, the whole society would benefit from this.

To protect farmers from natural disasters

According to the surveys in rural areas, the agricultural risk brought from natural disasters is still the most significant reason that the farm households cannot repay timely or cannot afford to repay (Cui and Jiajinrong, 2010). The local industry homogenization and the frequent natural disasters in recent years lower the ability of members in the group to repay or even deprive their ability. As a result, the loans from financial institutions cannot be paid off timely and they may become the non-performing loan (Kong et al., 2010). The suggestions of natural disaster are:

Reconstruct the agricultural insurance system

The group loan needs agricultural insurance to lower the risk because of natural disasters and the high degree of industry homogenization.

Establish the preferential tax policy and strengthen financial subsidies

On the base of experience of foreign agricultural insurance policy, the relative departments should strengthen the agricultural subsidies, especially the industries related to people’s livelihood such as the planting industry and livestock breeding industry. At the same time, the relative departments should also establish the preferential tax policy and enlarge the range of preferential tax to boost the development of farmers’ insurance.

Accelerate the development of agricultural insurance and reinsurance policy institutions

Because of the high complexity of agricultural production and agricultural insurance, the establishment of policy-oriented agricultural insurance institution is rather necessary, which regulate the management and operation of agricultural insurance. We also need to set up the reinsurance mechanism and risk-sharing mechanism, making sure that the smooth development of agricultural insurance in China realizing the target of insurance.

Strengthen the connection of agricultural insurance companies, banks and other financial institutions

On the one hand, banks and rural credit cooperatives can adopt the policy of evaluation and loan in advance according to the credit demand of farm households on the condition that farmer buy agricultural insurance. If the farmers who have bought the insurance lose money during the production, the agricultural insurance companies would compensate some of the loan, or even all. On the other hand, banks would provide some preferential loans to satisfy the need of agricultural insurance companies. At the same time, the banks could also substitute the insurance companies for current branches to sell the agricultural insurance to farmers. This method can promote the development of our agricultural insurance and improve the environment of financial credit for
farmers. Also, it can realize the goal of making profit and developing substantially of banks and rural credit cooperatives, achieving the win-win cooperation.

THE ROLE OF GOVERNMENT

Apart from the good insurance system, government can play more part in the group lending. In the country of Yunan in Guangdong, the Rural Credit Cooperatives adopted an innovative measure to carry out the microfinance. The credibility of farmers is evaluated by government, rural credit cooperatives, village cadres, etc. The assessment of credibility includes social and economic information, far more than the information acquired by banks. This method has the same advantages of group loan, but solves some of its problems at the same time. Up till now, this method is still fruitful.

However, the suggestion that the government should play more part in the group lending does not mean that group lending should be controlled by the government. Instead, it means that the government should be one of the significant subjects to provide information or to enforce the relative laws and regulations. At present, group lending is still regarded as the short-term measure to alleviate poverty in China, the goal which disobeys the general principle of economics. Once the local government stops the group lending, the farmers have no access to microfinance. Meanwhile, the total control of group lending by government may result in the waste of resources because of the low efficiency. Therefore, the power of government should be limited by the microfinance institutions and NGOs. NGOs can play the role as supervision of farmers, government and microfinance institutions.

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