BASIS BRIEF
Broadening Access and Strengthening Input Market Systems

Number 16 April 2003

Up the Lending Ladder: Extending Financial Services for the Rural Poor through Credit-reporting Bureaus

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The lending ladder

The last decade witnessed an exponential growth of microfinance institutions (MFIs) that have made credit available to millions of poor entrepreneurs in developing countries. Nonetheless, the "microfinance revolution" largely bypassed the rural poor's agricultural activities. With the disappearance of subsidized lending to agriculture and the reach of microfinance mainly confined to urban areas and nonfarm activities, lack of rural finance for agriculture remains a major gap in the provision of financial services to smallholders.

Formal lenders, such as state and private banks and credit unions, can offer competitive rates; yet, in most cases, the rural smallholder requires a loan too small to attract formal lenders, based on the associated risk and expected returns of the agricultural endeavor. Local moneylenders may be a more accessible source of small loans, but the interest rates often are prohibitive, and the terms are not conducive to agricultural activities. MFIs can offer a middle ground: potentially lower interest rates than a moneylender while also providing an easier first step up the lending ladder for smallholders who initially wish to borrow small amounts before entering into future contracts with formal lenders.

Progression up the lending ladder, however, requires an open environment of credit information. Without information about borrower histories being shared, borrowers cannot benefit from competition, nor can lenders make decisions about who is a good risk. Several Latin American countries have varying experiences with credit-reporting bureaus and therefore serve as a natural laboratory for researching ways in which these institutions impact the ability of smallholders to access credit from a variety of lenders, especially for agricultural activities.

Thanks to the microfinance revolution, a massive, often subsidized pool of information about borrower quality has been generated over the past decade that the private market would not have been able to afford. The incentives of the MFIs to divulge this information, however, have not always been aligned with the interests of the poor. It is hypothesized that the formal financial sector, given reliable information about poor borrowers' credit histories, would be interested to lend to the best among them.

The project "Credit-reporting Bureaus and the Deepening of Financial Services for the Rural Poor in Latin America," funded by BASIS CRSP, investigates the nature of credit-reporting mechanisms and how they have the potential to drive the resultant agricultural credit markets. Through careful analysis, the project can help guide best practices in the legal and regulatory formulation of credit-reporting systems, anticipate how they will transform access to credit for different classes of borrowers, and how they affect competition among rural credit providers.

Powerful, affordable policy tools to improve lending ladders in rural areas are in short supply. Therefore, the funding agencies and policymakers that supported the generation of the pool of borrower information may need to take action in order to guarantee its efficient use.

Bridging the collateral-risk dilemma

Rural poverty often seems more intractable than its urban counterpart. Yet, many smallholders hold title to the soil under their feet, endowing them with a valuable asset that could be used as collateral. Leveraging one's land into productive capital, however, can be too risky for the rural borrower. While the average expected return on an agricultural investment potentially allows a farmer to borrow profitably, smallholders may quite reasonably reject a lending contract from a formal institution because of the many risks beyond their control that could lead to forfeiture of their land.

In the agricultural sector, therefore, credit decisions among the poor are inextricably linked with the issue of insurance against risk. Making credit more attractive (and less risky) to farmers would require lowering the threshold level of collateral required to secure the loan. Without access to other forms of collateral, however, lowering the level of collateral provided to secure the loan increases the potential for problems of moral hazard and adverse selection for the lending institution. Therefore, the formal lending sector primarily relies on collateral to avoid these problems, or avoids the agricultural sector altogether.

MFIs solve the moral hazard problem more easily than do commercial banks by working closely with communities. Through their most common arrangements, MFIs allow their members to make joint-liability insurance decisions, since they possess good information about other potential borrowers within the group. Though the small, short-term loans provided by MFIs generally do not meet the needs of the farming community, they can be used by rural borrowers for nonfarm activities while they build a solid reputation. When borrowers are able to signal their creditworthiness and lenders have clear access to this information, then rural households can leverage agricultural investment credit at an acceptable risk to themselves and lenders can minimize risk by contracting with individuals with proven credit histories and offering them limited liability insurance on loans. By capitalizing on a good credit history, poor farmers could thus secure longer-term, larger, and more individualized loans without jeopardizing their landholdings.

Why information matters

There are three levels of information sharing between institutions: *No information sharing*, where only social collateral can enforce repayment; *default sharing*, where lenders can identify only those borrowers to whom it might be risky to lend; and, *full information sharing*, where a credit-reporting bureau can provide information on borrowers' repayment histories and current debt exposure. In this latter case, the best borrowers can be separated from the rest, and lenders can identify to whom they should first offer contracts with more insurance.

Yet, without the institutional infrastructure for full information sharing of the type that exists in developed economies and is rapidly emerging in many developing countries, the relationship between a borrower and an MFI remains secret, so that a borrower with a strong credit record is unable to publicly signal his or her creditworthiness to the market as a whole. Thus, the chance to benefit from competition among potential lenders is lost. Without the opportunity to observe repeated loans successfully repaid, a lender cannot infer client quality or be in a position to offer loans with more insurance. If borrowers are to climb the lending ladder to the more formal financial institutions, they must escape credit relationships that remain strictly private.

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The early expectation of the microfinance movement was that successful clients would "graduate" to the formal sector. Naturally, though, MFIs tend to be reluctant to let go of their better clients. This has proved true even for lenders with social (rather than profit-driven) motives, as their best clients are a source of revenue that could be used to subsidize other, often poorer, clients. Thus, keeping information about good borrowers secret is a survival strategy for MFIs that can prevent the best borrowers among the poor from climbing the lending ladder.

A system of "internal graduation" has evolved in most major MFIs whereby the best clients are offered access to more individualized loans, usually at lower interest rates but still within the original institution. Since there is no reason to believe that an MFI is better at offering individualized loans than a bank, some MFIs must be leveraging their information advantage in order to identify and retain the best clients. Without information sharing, this upward diversification of lending technologies might continue indefinitely, pushed in particular by the increasing competition among MFIs that is especially prevalent in Latin America.

Should formal lenders have access to information about households' time preferences (derived from their MFI borrowing histories), then they might be able to offer them loans, even if these clients do not have alternative sources of liquidity to protect the collateral (farmland). This is likely to have the greatest impact in semi-rural areas where households control farmland but also are engaged in extensive sideline and off-farm activities that made them good clients for MFI loans. Additionally, it might also spur more lending to the rural poor for their agricultural activities. Consequently, availability of such crucial information would seem to be one key to unlocking rural poverty.

Understanding credit bureaus

If credit in the agricultural sector lags behind credit in urban areas due in large part to a lack of borrower information, then it would be beneficial to discover how credit bureaus might cause information to flow more freely and help extend sustainable credit markets into rural areas. Credit bureaus allow formal and informal lenders to observe borrower quality and so create competition where formerly borrowers had been subject to "informational capture" by their original lender. Because credit histories allow for detailed evaluation of individual attributes, they may facilitate extending insurance to borrowers who would otherwise be unknown risks.

A natural experiment has been created by different policy responses in several Latin American countries. In some countries, such as Nicaragua, very little client information is shared on a formal level despite flourishing MFI competition. In contrast, El Salvador has developed the *Info-Red* system, which is a modern, computerized full information sharing credit-reporting bureau. Peru and Guatemala present interesting intermediate cases. In order to determine the impact credit bureaus and *full information sharing* have on access to credit for rural households, competition among MFIs, and graduation of borrowers to the formal financial sector, this project will analyze three complementary types of data sources: an internet census of credit bureaus, administrative data from cooperating MFIs, and an entry survey among formal lenders to agriculture. Hypotheses around the following questions will be analyzed:

- Do credit bureaus improve the transfer of borrowers from the MFI sector to the formal agricultural lending sector? If so, through which channels?
- What impact do different credit reporting regimes have on different kinds of borrowers?
- How does the impact of credit bureaus vary with the characteristics of the local region or of the lender?
- What determines the process that matches certain types of borrowers with specific lenders?
- What are the strategic and legal barriers to introducing credit bureaus?

Identifying policy tools

The internal accounting data collected by MFIs and formal agricultural lenders present a rich source of information with which to examine the effects of credit sharing systems. These accounts represent a full individual panel, and so they allow for a detailed, time-series analysis of the impact of national-level reforms. Because the accounts data project back for the life of the institution, in general, BASIS researchers can examine the effects of shifts in information sharing in a variety of contexts. Regional data, as well, are important in giving us basic information on shifts in the local context.

BASIS researchers can examine the effects of shifts in information sharing in a variety of contexts

This project examines whether credit bureaus in fact can improve the transmission of clients from the MFI to the formal sector, and whether the level of debt rescheduling or other insurance mechanisms increases when there is full information sharing. We hope to clarify the process that matches borrowers of a certain type with a given kind of lender, as well as to understand the types of borrowers who are assisted by the emergence of credit reporting. In a broader sense—with an eye to guiding best practices in tailoring credit bureaus to local conditions—the project seeks to discover the barriers to introducing credit bureaus for full information sharing.

There are strong reasons to think that information sharing may not emerge spontaneously as an equilibrium contract between MFIs, and so the political process

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Briefs

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Publication made possible by support in part from the US Agency for International Development (USAID) Grant No. LAG-A-00-96-90016-00 through BASIS CRSP.

Edited and layout by
BASIS CRSP

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required to engender them needs to be studied. We cannot speak with clarity about the "lending ladder" that elevates the rural poor towards increased profitability until we have a firm understanding of where the rungs are, which clients are offered a ladder, and who wants to make the climb.

This policy-oriented project includes training for policy analysts and dialogue with policy-makers. Overall, the project expects to help resolve a major remaining frontier in using financial services as an instrument for poverty reduction: providing access to loans for the rural poor in their agricultural operations.

Banking on a good name

The lack of access of poor MFI clients to formal lenders is largely the result of lack of guarantees and insufficient information on past borrowing performances. With policy initiatives for incorporating the rural poor in peri-urban income strategies as clients of MFIs, rural households can establish public reputations about credit histories through the development of credit information sharing systems, leading to greatly improved access to formal loans for good borrowers.

Farm households, prevented from formal borrowing due to risks they are unwilling to take, may face better prospects if they are able to leverage their reputation gained through a successful borrowing history with an MFI. A bank, convinced of a borrower's creditworthiness, should be willing to offer a greater degree of insurance against risk through loan rescheduling in case of shocks. While loans based on a borrower's good reputation cannot eliminate risk, they may substantially weaken this constraint so that many more successful agricultural lending contracts are made.

A good reputation is one of the few assets to which the poor have equal opportunities. This project will analyze institutional innovations that allow the maximum leverage from a good name, and so increase social mobility for the poor. Credit reporting bureaus may allow policymakers a unique, cost-effective way to help the poor leverage their assets, including their good name, thus creating a tool that is likely to be effective in increasing access to credit for poor farmers.

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