The Importance of Building Trust for the Success of Microfinance Institutions

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Abstract

In the 1970's, Nobel Peace Prize winner Muhammad Yunus demonstrated that an act as simple as trusting the poor facilitated successful loans and repayments, in spite of common opinion to the contrary. This essay reviews current literature on the role of social capital, and trust in particular, as a driver in the success of Microfinance Institutions (MFI's) in terms of self-sustainability and poverty alleviation. It has been shown that trust is in fact a necessary condition for MFI's to achieve success. This is primarily because trust building in communities enables MFI's to successfully overcome market failures such as high transaction costs, asymmetric information, and lack of collateral among the poor. It moreover appears that while higher levels of social capital in a community can improve MFI success, MFI's are in a unique position to shore up existing levels of social capital and trust. Because social capital and especially trust are important elements at all levels of MFI interactions, MFI success can potentially have a mutually re-enforcing effect with social capital. Nevertheless, more research is needed to understand the relationship between social capital and microfinance, levels of trust in MFI interactions, and the mechanisms which can promote higher levels of social capital and trust in communities. If these mechanisms and relationships between social capital and microfinance can be understood better, it bodes well for higher MFI success rates and improved economic growth among the world's poor.

1. Introduction

Social capital and Microfinance Institutions (MFI's) are both hotly debated topics in social sciences today. Authors such as Van Bastelaer (1999), Karlan (2002; 2005) and Sriram (2005) have looked into the specific role that social capital plays in MFI's in overcoming market failures that traditionally limit access to financial services for the poor. Because trust, a form of social capital, plays a key role in economic transactions, it is essential to understand the role that social capital plays in poor communities so that the potential for development can be harnessed. This essay will review current economic literature and begin by analyzing the role of trust in microfinance institutions (MFI's), followed by an analysis of the causal relationship between social capital, with an emphasis on trust, and the success of MFI's according to a mission objective of poverty alleviation. It will then demonstrate that MFI's not only rely on existing social capital to succeed, but are also able to generate a higher level of social capital within the communities of operation. This will finally be juxtaposed to the difficulties of using and measuring trust in MFI's.

2. What are Microfinance Institutions?

Microfinance as it is known today is a practice that is about 40 years old and represents a collection of financial services that include credit, savings, insurance, and remittances (Guerin 2006). Microfinance is used to increase economic wellbeing as well as address issues of social inequality across the globe (Armendariz and Morduch 2010). Improving livelihoods of the poor is most often the goal of microfinance, but being a microfinance institution does not necessarily mean that the social mission outweighs the need for the institution to be self-sustaining, and possibly even profit-seeking. This essay will show that social capital, and trust in particular, can be both a process of reaching these goals as well as an indicator of success for MFI's.

3. Defining Social Capital

Social Capital has numerous definitions in each of the social sciences. In economics, it most typically defined in terms of social mechanisms which have an economic impact. According to Martin Paldam (2000), the three most important definitional concepts in social capital are trust, ease of cooperation, and networks.[1] There are numerous authors who have attempted to formalize a definition for social capital such as Hayami, who suggests that social capital should be defined as "the structure of informal social relationships conducive to developing cooperation among economic actors aimed at increasing social product, which is expected to accrue to the group of people embedded in those social relationships."[2] This is a synthesis of Putnam (1996, p.66) and Coleman (1994, p. 302), which Hayami utilizes to adopt the 'community' into the economy of the market and the state. Although this definition introduces community members as economic agents, it only applies to those social interactions and relationships that have a *social* product. Nan Lin instead provides a simpler and perhaps more intuitive definition where the notion where social capital is simply "investment in social relations with expected

[1] Martin Paldam (2000). "Social Capital: One or Many? Definition and Measurement." p.629-30, 649.
[2] Yujiro Hayami. "Social Capital, Human Capital and the Community Mechanism: Toward a Conceptual Framework for Economists." *Journal of Development Studies* 45.1 (2009): p.98.

returns in the marketplace."[3] Dr. Lin's definition is advantageous as it expands the notion of social capital to include any social relationship that has a positive outcome in the marketplace, which is easier to measure and thus a more convenient concept to apply in economic studies of social capital. It is moreover consistent with the approach of Coleman (1994) and Putnam (1996). For the purpose of this essay, trust was selected over cooperation and networks as the primary indicator of social capital as it is the focus of most academic literature on social capital in microfinance, and is moreover the easiest one to measure empirically (see for example Karlan 2005).

4. Trust and Transaction Costs

Trust plays a central role in the financial markets.[4] Humphrey and Schmitz have written extensively on the role of trust in facilitating economic exchange (1996) and in economic growth among developing countries (1998). Not only is it necessary for industry to attain a competitive advantage, but they identify extended trust as the key in promoting co-operation in supply chains and clusters, which is crucial for economic growth. Humphrey and Schmitz furthermore argue that trust is an imperative for establishing an effective market economy.[5] It also appears that the fundamental necessity for trust in a well-functioning economy cannot be overridden by institutions: Fukuyama (1995) explains that in communities where the legal apparatus is a substitute for trust, transaction costs are effectively higher. M. S. Sriram (2005) highlights these authors' work to argue for the importance of building trust among communities for microfinance institutions to successfully overcome market failures such as high transaction costs,[6] asymmetric information,[7] and lack of collateral among the poor. He shows an example of microfinance Institutions in India that actively sought to reduce transaction costs by increasing the level of trust between financial intermediaries and poor rural borrowers; a trust that had been eroded by corrupt and poorly run state-subsidized rural lenders who often waived loans.[8] Sriram thus characterizes the role of MFI's as building up trust to bridge "the gap between the need for financial services across time, geographies, and risk profiles" among the poor that arise out of market failures.[9]

Trust is thus essential not only for conventional market transactions but also for the success of MFI's. According to Sriram, the innovation in microfinance that bridges the information, risk and time

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[3] Nan Lin. *Social Capital: A Theory of Social Structure and Action*. Cambridge, UK: Cambridge UP, (2001): p.19.
[4] M. S. Sriram (2005). Information asymmetry and trust: A framework for studying microfinance in India. p.79.
[5] Humphrey (1998) Trust and inter-firm relations in developing and transition economies. p.32-3
[6] Transaction costs are the costs occurred during an economic exchange. In microfinance, it is essentially the cost of servicing a loan to the poor, which has been described as the theoretic reason for lack of financial services among the poor by conventional banks. Unfortunately it is often a real barrier to MFI's due to the high level of personal interaction needed between borrowers and bank agents.
[7] Asymmetric information is the market failure whereby one party in an economic transaction has more or superior information than the other. This can lead to problems in micro credit institutions when for example a potential borrower cannot be screened for risk, which is the adverse selection problem, or when a borrower has invested a loan but the lender is unable to verify any of the information provided; this potentially leads to shirking or running away from the loan, which are moral hazard problems.
[8] M. S. Sriram, Ibid.: p.79-80.
[9] Ibid.: p. 78.

gaps[10] is what he labels "a series of trust-based surrogates."[11] As Sriram explains, basic opportunities for financial transactions initially arise out of asymmetries between the demand and supply for financial services, i.e. there are some who at some point or another are net savers and others that are net borrowers. However, when this gap cannot be bridged between high-income savers (that typically live in urban areas) and poor rural would-be loaners due to lack of information and high risk, the asymmetry of financial supply becomes an example of market failure.[12] Sriram argues that MFI's effectively use trust in group lending among rural communities to overcome such market failures. Trust, which he sees as a function of information, can lower transaction costs in several ways, most notably through reduced use of documentation (direct transactions with a representative lender) and peer-monitoring which reduces the riskiness of borrowers.[13]

Other authors such as Thierry Van Bastelaer (1999) similarly argue that MFI's successfully surmount market failures when dealing with the poor by utilizing both existing social capital in communities as well as creating social capital between borrowers and loan institutions. Van Bastelaer explains that social capital in local communities ensures repayment through "social collateral," (i.e. the borrowers reputation in the networks they belong to), and that (some)[14] MFI's lower the information gap through the group-lending model. Group-lending lending does this on two ways: first, it builds continuous relationships built between loan officers and borrowers which creates trust between borrowers and the institution; second, by use of joint liability contracts[15] to overcome the information gap. Joint liability contracts are seen as a cost-effective way of incentivizing borrowers to use their knowledge of other group members in screening people (thus overcoming the adverse selection problem), engage in peer monitoring (which overcomes moral hazard), and exerting peer pressure (enforcement) to ensure repayment (Van Bastelaer 1999; Ghatak and Guinnane 1999).[16] Whether an MFI engages in group-lending or not, there is academic consensus that social capital (and trust in particular) is the vital to ensuring the success of MFI's, with success being defined as having high repayment rates by members, and moreover as MFI's achieving their social mission objective of helping the poor.

This phenomenon has led academics to explore the direction of causality between social capital and the success of microfinance institutions: do MFI's use existing social capital in communities to

[10] Sriram describes the time gap as the problem of differing needs of finance at differing points in time, which he says is solved by a person's own financial supply through setting up a savings account with an MFI.
[11] Ibid.: p. 77.
[12] Ibid.: p.78.
[13] Ibid.: p.83.
[14] Van Bastelaer does not distinguish between those MFI's that do or do not utilize group-lending, although it is far from all which do. The most well-known MFI, Grameen Bank, still uses group-lending but has interestingly stopped utilizing joint liability contracts since it finished rolling out its new structure, Grameen II, in August 2002 (Rutherford et. al. 2004)
[15] Joint liability contracts are when groups share liability for the repayment of a loan. If one person defaults, all group members face the consequences such as for example the inability to borrow more money and loss in social standing.
[16] Van Bastelaer, Ibid.: Pg. 8-9; Maitreesh Ghatak and Timothy W. Guinnane. "The Economics of Lending With Joint Liability: Theory and Practice." Pg. 196-98.

become successful (according to the two objectives mentioned above), or do they increase social capital (trust) by becoming successful? The next two sections will analyze this question.

5. Do Microfinance Institutions Create Social Capital?

MFI's can serve to elevate existing social capital in communities. Asif Dowla (2006) uses Grameen Bank in Bangladesh as a case study to show that microfinance Institution create social capital among the poor. Using Putnam's (1993) definition of social capital as "features of social organization, such as trust, norms and networks that can improve the efficiency of society by facilitating coordinated actions,"[17] Dowla explores the importance of social capital for development and whether non-state institutions such as MFI's can create and maintain social capital. He explains that Grameen Bank was created in a spirit of strong trust in their clients and a focus on hiring trustworthy employees, and the high level of trust placed in their clients is reciprocated by members paying back on time.[18] Because a high level of trust is needed to facilitate successful loans and repayments, Grameen realized that "to ensure … credit delivery ultimately leads to qualitative changes in the lives of the members, the bank had to create and cultivate social capital."[19] Grameen bank is therefore a success story of how an MFI can increase social capital in communities which in turn lead to the bank's own success.

Pronyk et al. (2008) undertook an empirical study to determine how social capital can be intentionally generated by microfinance activities. By conducting a two-year intervention in rural South Africa that combined a microfinance program together with a training program on HIV and gender issues, Pronyk et. al. show that a multi-level approach to community development centered around microfinance services resulted in a measurable increase in social capital in the community (measured by both interviews and community organization membership). They furthermore argue that the social capital increment was a substantial contributor towards improved health services in the community, which demonstrates the importance of a multi-faceted and inclusive approach to development. Based on their findings, Pronyk et. al. argue that social capital can be intentionally generated over a relatively short time frame, in contrast to Putnam (1993) who claims that social capital only accrue over a long period of time.[20] A study by Feigenberg et. al. (2010) corroborates the findings of Pronyk et. al. They conducted an empirical study of group-lending practices in Grameen-styled banks in India to see whether increasing interactions among community members can increase economic cooperation. Feigenberg et. al. found that more frequent interactions with loan officers strengthened social ties among loan group members and increased financial transactions outside the group. It also led to a four-fold decrease in default rates. Although it has earlier been shown by Grameen in Bangladesh that more frequent repayments make people less likely to default on their loans, the authors found in their study that "social ties were the central channel of influence" on default rates. Feigenberg et. al. conclude that

[17] Robert D. Putnam and Robert Leonardi (1993). *Making democracy work: Civic traditions in modern Italy.* p.167
[18] Asif Dowla (2006). In credit we trust: Building social capital by Grameen Bank in Bangladesh. P.105, 107-8
[19] Ibid.: p.19.
[20] Paul M. Pronyk et. al. (2008). Can social capital be intentionally generated? A randomized trial from rural South Africa. P.1559, 1561, 1568.

MFI institutions not only harness existing social capital but in fact build new social capital among borrowers, an effect which has the potential to spur economic development.[21]

6. Is Social Capital Necessary for the Success of Microfinance Institutions?

Microfinance institutions have varying mission objectives and sometimes several, such as improving the livelihoods of the poor while achieving economic self-sustainability. Social capital has been found by many authors to be essential for the success of MFI's, regardless of their core mission; while expanding social capital increases the success of microfinance members, it also promotes the self-sustainability of MFI's by giving higher repayment and saving rates. An empirical study by Gomez and Santor (2001) has for example shown that social capital is one of the key determinants of success for small-scale entrepreneurs (determined by earnings). Particular to MFI's, Dean S. Karlan (2005) has shown in his paper titled "Using Experimental Economics to Measure Social Capital and Predict Financial Decisions" that trust, as a component of social capital, helps solve market failures and in turn can be used to predict the success of MFI's (as determined by repayment rates). In particular, the article used the Trust Game[22] to show that trustworthiness can overcome the lack of contract enforcement through a measurable positive impact on repayment rates (versus trust, which could not be measured), and thus is an important component in determining the success of group lending schemes.[23] These studies both demonstrate the importance of harnessing social capital to help solve the market failures involved with providing financial services to the poor, namely asymmetric information (which includes adverse selection and moral hazard) and lack of collateral.

Social capital operates on multiple levels of microfinance transactions. Karlan shows in an empirical study from 2002 that social capital, as already established, first helps overcome the market failures that arise out of imperfect information and lack of collateral. Second, the group-lending model includes frequent meeting with a loan officer as well as joint liability contracts, and as Karlan explains, social capital in group-lending programs "facilitates the monitoring and enforcement of joint liability loan contracts."[24] These mechanisms reduce transaction costs from the indirect monitoring of the loan officer, increase peer-monitoring from the joint liability contracts, and facilitate a higher level of trust (or "reputation values") that promotes further economic transactions in the community.[25] It is noteworthy that cultural homogeneity further reinforces this effect, since "strong social connections between two

[21] Feigenberg, B., Field, E. M., & Pande, R. (2010). *Building social capital through microfinance* (No. w16018). National Bureau of Economic Research. p.1-3, 28.

[22] The Trust Game is a version of the Dictator Game used in experimental and behavioral economics to test the economic behavior of a participant given that the most desirable output requires that trust be placed in his or her partner.

[23] Dean S. Karlan (2005). "Using experimental economics to measure social capital and predict financial decisions." p.1688-9, 1698.

[24] Dean S. Karlan (2002). *Social Capital and Microfinance*. P.25.

[25] Karlan echoes the findings of other authors by noting that the increased level of social capital and trust thus helps overcome low repayment rates among the poor and improves self-sustainability of the MFI. Conceivably, the increase in economic transactions from higher trust in the community advances development in the area, which is another success factor for an MFI.

individuals make both monitoring cheaper and the threat of enforcement more effect."[26] In the 2002 case study it was furthermore found that loaners of the NGO with access to savings accounts, whose interest rates were a function of group return minus default rates, were able to create loans out of those savings and thus further increase their savings rate. This could only be possible if the account holders felt that their savings were safe. As Karlan notes, "social capital influences each input into this formula… higher social capital leads to lower default, and since defaults are covered by the group's savings, lower default directly implies a higher return on savings." Since many groups did not invest their savings if they lacked safe projects, groups with higher social capital furthermore lend out a higher percentage of their savings.[27] Social capital therefore shores up the success of microfinance projects at almost all levels of a transaction.

7. Potential Criticisms

Some authors have however warned about possible negative effects of social capital in microfinance. As Smets and Bähre point out, over-reliance on trust in microfinance and self-help organizations can backfire. Cooperation and success is almost exclusively based on trust among people whose financial futures are insecure, and neighbors may for example confiscate property when a group member defaults on their loan.[28] Humphrey and Schmitz (1998) explain that a high level of trust in small trading communities creates a strong *need* for sanctions in order to contain the risks involved.[29] Smets and Bähre moreover claim that microfinance may weaken some existing aspects of social capital, which is counterproductive, since the introduction of new networks may destroy old relationships; this would drastically reduce the effectiveness of MFI's.[30] Therefore, in communities with weak social networks, MFI operations can be risky unless the organization targets reinforcement of existing networks. As Ledgerwood points out, "it is easier to establish sustainable financial intermediation systems with the poor in societies … with [existing] high levels of social capital."[31] It appears that MFI's need to carefully deliberate how social capital can promote their mission goal and structure their program accordingly.

Another problem with social capital and trust in microfinance is the difficulty of measuring it. Sanae Ito (2003) argues that the connections between the effects of social capital (information sharing, cooperation, trust, etc.) and the design of microfinance programs based on the group-lending model are more complex than commonly assumed. She concludes that social capital has little or no explanatory power on the success of MFI's: the social capital inherent in the relations between lenders and borrowers cannot be conclusively shown to be positive or negative, and thus "may or may not operate to strengthen borrowers' credit discipline."[32] This is reminiscent of the issue faced by Karlan's (2005) empirical study: although a measurable impact from trustworthiness could be established, trust of other

[26] Ibid.: p.19.
[27] Ibid.: p.23.
[28] Peer Smets & E. Bähre, (2004). "When coercion takes over: The limits of social capital in microfinance schemes." p.218, 224.
[29] John Humphrey and Hubert Schmitz (1998), Ibid.
[30] Ibid.: p. 217
[31] J. Ledgerwood, (1999) "Rural Development in Cambodia: The view from the village."
[32] Sanae Ito (2003), Microfinance and social capital: does social capital help create good practice? Pg. 330.

economic agents could not be established. As Ito, Karlan and others have pointed out, the exact nature and impact of social capital on economic transactions still requires much more research.

8. Concluding Remarks

There is no disputing that trust is an important component in economic transactions. Many authors also believe that trust is vital to achieve a high level of growth, and interestingly, Dowla (2006) has found that MFI's improve the chance that developing countries can use social capital for development. This literary review has shown the importance of trust as a component of social capital in helping microfinance institutions achieve their aim of helping the poor become successful micro entrepreneurs and/or become self-sufficient institutions by overcoming market failures. Specifically, the market failures that typically stop the poor from obtaining financial loans are adverse selection, moral hazard, and lack of collateral. Adverse selection and moral hazard are also known as the asymmetric information gap, and the lack of collateral is instrumental in creating what Sriram (2005) described as the financial gap across geographies; a high level of trust has the potential to overcome all of these gaps.

This essay also sought to give an overview of the literature that describes whether social capital and trust result in the success of MFI's or whether it is the MFI's that build up trust in the communities they operate in. With the exceptions of the few authors who find that evidence to be conflicting or inconclusive, it appears that there is much to be said for causality to exist in both directions; social capital and especially trust are important elements at all levels of MFI interactions, and MFI success can potentially have a mutually re-enforcing effect with social capital. As Feigenberg et. al. have found, MFI's can both capitalize on existing social capital as well as create new social capital given the right institutional lending structure. Nevertheless, more research is needed to understand the relationship between social capital and microfinance and in particular the mechanisms which can promote higher levels of social capital and trust in communities. Social capital can be difficult to measure since it is such a qualitative concept, but as Karlan (2005) has shown, trust is a promising variable because it can be measured using tests from Game Theory. If its determinants and connection to MFI success can be better understood, social capital has great potential for boosting economic growth in developing countries.

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