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Bachelor Thesis

Microcredit allocation and borrower selection

A qualitative study of microcredit allocation in Ecuador

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Executive Summary

Following Noble Prize winner Muhammad Yunus, each and every person would have enough potential skills to escape poverty, but due to social restrictions large parts of society have very limited or no access to the formal financial markets. This though and the possibility to establish their own micro-businesses might be for many of these people – mostly located in developing countries – the only way to escape poverty. Microcredits, as being the nucleus of what is known today as microfinance, may thus be one of very few solutions to overcome these conditions. Such microloans – on the back of information asymmetries – bear though at the same time high risks. These risks need to be minimized in order to establish a sustainable microfinance industry that is able to reach its financial goals and at the same time fulfills its purpose to create social welfare.

However, while credit features as well as lending methodologies have been examined quite extensively, less research has been done on the specific process of allocating and selecting microcredit customers as well as the subsequent monitoring. The thesis at hand tries to build a framework to overcome this research gap. In order to achieve this, the author outlines and clarifies first the theoretical backgrounds of microfinance, with a special focus on microcredits. Hereby the author tries to clearly illustrate differences between the two major lending methodologies, being individual and group lending. Then, in the second part the author draws an in-depth picture of the microcredit market in Ecuador, based on publicly available information as well as through a qualitative survey conducted to 53 MFIs.

Comparing theory with praxis let the author conclude that although the first is strongly reflected in the latter, country specific characteristics indeed need to be taken into consideration in the borrower's selection and allocation process. The author for instance can show that individual lending is predominantly applied in Ecuador due to the fact that the country has a rather mature microfinance market. The recent shift from group to individual lending will be outlined and reasons provided. As a consequence, not surprisingly specifics of the borrower's selection process used in the individual lending method can also be found in group lending set-ups. An example of such is the requirement to provide some documentation even though borrower's screening should be transferred to the group itself. Moreover, the author finds evidence that not only in individual, but partially contradicting to theory also in cases of group lending, focus in Ecuador is rather on already existing micro-businesses than on start-ups. Moreover, the

author can show that individual lending, as it was assumed, uses dynamic incentives while group lending rather focuses on peer monitoring and peer pressure in order to ensure timely repayments. Overall though, monitoring could – in the opinion of the author – be further expanded.

With regard to the question whether different financial market environments influence the microlending process, it can be said that due to the increasing existence of prudential regulations that look after the stability and transparency of the financial system, as well as the use of special credit information systems, this impact has been reduced. This is proven in the survey and let the author conclude that from a MFI's perspective it is becoming more and more important to have reliable external sources to rely on.

Summarizing above outlined detailed results, the author states that in order to be able to set up a truly sustainable model, country specifics as well as specifics of each clientele need to be incorporated in all steps of the lending process Only if that is the case, and only if a good and in-depth understanding of the borrowers is ensured, microcredits can truly play their obvious strengths.