MANAGING NON-REPAYMENT RISK THROUGH GROUP-BASED LENDING IN MFIs

The Case Study of Khushhali Bank Limited, Pakistan

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Title: Managing Non-Repayment Risk through Group-Based Lending In MFIs: The Case Study of Khushhali Bank Limited, Pakistan.

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Purpose: To analyze how MFIs are managing their non-repayment risk by using GBL approach.

Method: The deductive approach has been used in this study and the case study method is deployed. Khushhali Bank Limited, Pakistan has been taken for the subject MFI.

Theory: The four inter-related theories have been taken into consideration, namely Portfolio, Principal-Agent, Contract and Transaction Cost Theories, to have a detailed literature review about the threat of non-repayment risk through GBL.

Results: The study chalked out a result that by combining diversified members in a group under GBL approach, MFIs can able to minimize their non-repayment risk.

ABSTRACT

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Muhammad SALMAN Qureshi
DEDICATED TO MY PARENTS

For two most lovely persons of my life Mr. & Mrs. Abdul WAJID Qureshi...To whom I belong to and they gave their love & support to accomplish my dreams…

Thank you for your unconditional support with my studies. I am honored to have you as my parents. Thank you for giving me a chance to prove and improve myself through all my walks of life. Please do not ever leave me alone. I Love you.
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Chapter 1

INTRODUCTION

1.1. BACKGROUND

With the onset of the 21st century, there is a widespread acknowledgement among the nations of the world to uplift the standard of living of their people. Especially developing countries which constitute major population of the world need to make serious efforts towards the welfare of their impoverished masses. They are dreaming of the prosperity, alleviation of poverty and fulfill the financial needs of all the households despite of rich and poor in the social society. Morduch (1999) describes that in remote corners of the world, enthusiasm is building about a set of unusual financial institutions prospering particularly in Asian countries. The only hope in this regard, is to provide financial services to the low income households in order to alleviate poverty. Traditional banking institutions have been unable to cater the needs of the impoverished segments of the society due to that poor has been out of the financial services because of the collateral and danger of non repayment. According to Morduch (2000), poor households remain un-served by the traditional banking system because of the inability of the poor households to fulfill the requirements of collateral (guarantees). As a result many individuals are unable to avail bank loans despite having valuable and innovative ideas due to their inability to comply with banks collateral requirements. This dilemma is detrimental for a nation’s long term growth and development. According to Nieto et al. (2005), banks do not offer loans to relatively poor people who are unable to fulfill the conditions of loan collateral but who have innovative and feasible ideas that have the ability to become profitable ventures. The poor segments could not avail the credit facilities due to
a variety of reasons for e.g. the poor were not financially in a position to comply with the collateral requirements set by commercial banks, the poor segments lacked the access to formal credit facilities because they resided in far flung areas, the poor lacked the adequate amount of financial literacy needed. According to Abbink et al (2006), poor people opportunities to take loans had been limited by several reasons:

- They could not provide collateral to backup their loans because of their too few substantial possessions,
- The potential addressees of loans in developing countries resided in remote rural areas which lacked an access to the traditional banking system, and
- Loans needed for individual projects are small their myriad nature makes monitoring and enforcement costs prohibitively high.

It’s not solitary the poor who were facing the problems in taking loans but also the banks as well in lending to the poor. Morduch (2000) explains the banks’ few problems which are as follows:

- By lending on small scales, banks have to face high transactions costs per loan.
- In case of poor clients plus living in informal sector, banks found it hard to determine the riskiness of prospective borrowers and their monitoring, and
- Plenty of low income households lack assets as security of their loan.

Therefore, they don’t look the greater part of the population as the potential customers for their credits as they are living under the line of poverty. The conventional commercial banks are known for making treasures and seeking to maximize it for eternity. They always got a least amount of interest in focusing the poorest customers of the region due to the insecurity of loan’s repayment. That dilemma leads poor to the local financial authorities to borrow money that can be any rich person in their surroundings or the unofficial money lenders
whenever they were in a serious need of money. According to Robinson (2001), much of the financial services are rendered on a wide range of numerous, opposing, and financially self-sufficient institutions for the economically poor people in many developing countries. Sometimes they managed to have a pool financial system (e.g. called ‘Committee System’ in Pakistan) as they are really in need of financial support. According to Brau et al (2004), poor households are excluded from the formal financial systems. This absence, in the formal financial services, made them to develop a wide variety of informal, community-based financial arrangements to meet their financial needs. Cull et al. (2008) interpret that the process started in 1970’s held that generous subvention were required to run financial institutions serving poor households in low-income countries. The manifestation of the poor people that they can be reliable as bank customers is the supreme achievement of micro financing. Micro financing has taken the pace particularly in developing and the under-developing countries for last couple of decades. In a period, plenty of financial services were made and many economic policies have been designed particularly for potentially poor part of the population those are living under the line of poverty. Microfinance Institutions (Henceforth MFIs) were made on the commitment of facilitating poor households as they have been neglected deliberately so far from the conventional banking system. Hardy et al. (2003) says:

“Microfinance Institutions refer to those financial institutions that are characterized by their commitment to assisting typically poor households and small enterprises in gaining access to financial services” (pp. 148).

Hardy et al (2002) stated that MFIs appear to promise a way to grant an especially valuable form of assistance straight to the disadvantaged sections of the society in comparatively cost-effective manner. There is a widespread need across the developing world for institutions that can provide loans to the poor segments without the collateral requirements because poor segments are not financially able
to fulfill this requirement. Availability of loans to poor segments shall provide them with a chance to contribute towards the national growth and development. Nieto et al. (2005) tell that the MFIs offer small loans to poor people who can present little or no collateral assets. MFIs can definitely play an active role in uplifting the living standards of the poor masses. Indeed, the several well-intentioned governments’ interventions aimed at encouraging institutions but yet their outreach in rural areas remains low due to the perception of high non-repayment risk (The World Bank, 2008).

1.2. PROBLEM DISCUSSION

MFIs prudently tackle those problems that prevent the availability of loans to the poor (for detail you can see Chapter 3: Theoretical Framework). But the problem was that due to the prevalent of the threat of non-repayment risk in lending activities, MFIs were not as different from the current conventional banks and therefore also needed collateral against the loan. According to Hardy et al. (2003), barriers that prevent access of loans to poor people comprise mainly of risk factors and high operational costs. Risks factors in case of poor borrowers is more pronounced because:

- The income of the poor masses is intrinsically riskier and is more likely to be exposed to the exogenous risks e.g. macroeconomic fluctuations and weather.
- These possess fewer assets physical or financial.
- Loans are bound up with personal finances of poor (e.g. a business might collapse if large medical bill must be met).

MFIs always keen to generate ideas and formulate new techniques of lending in order to make a difference among conventional lending and micro financing. Singh (2007) drawn-out that MFIs’ lending approaches are far different from the traditional lending those having a base on assets, heavy collateral, guarantees and insurance of payments; while MF lending is totally based on trust and
operates without any insurance. MFIs have adopted mostly the two techniques or methodologies to lend the people living under the line of poverty, which are:

- **Individual Lending**
- **Group-Based Lending (Henceforth GBL)**

Since numerous years, individual lending has been the only lending approach in the entire lending world. Lending concept always bring individual lending first in the mind but the uncollateralized loans’ phenomena (known as the major difference among microfinance and traditional banking system) made its faith in individual lending weaker than GBL. Because MFIs are well-aware that their target market (poor households) is not able to provide sufficient insurance of the loan what they need. Due to this reason, MFIs are focusing more on GBL than individual lending. Kunt *et al.* (2007) find that GBL or joint-liability lending diminishes the monitoring cost and thus allows lower interest rates those reduce the repayment burden and result in less credit rationing. But serving the target market as per mission is something else and being on the safe side from the non-repayment risk is something else. According to Singh (2007), majority of MFIs are using GBL approach, some MFIs also lend directly to individuals without any sort of guarantees, but the risks are high in the case of individual lending. Thus individual lending is more likely than GBL to require collateral to cover the risks.

These problems can be countered by novel ways and techniques. Abbink *et al.* (2006) present GBL as an effective way to brace against the risks associated with lending loans to poor borrowers. The GBL advocates joint liability. Morduch (1999) stated that MF appears to offer a “win-win” solution in the shape of GBL, where both the financial institution and the poor household profit. In typical microfinance schemes, borrowers with individual risky projects form groups that apply for loan together. In case of default by one member the other members of the group have to compensate. The idea behind this approach is to provide
insurance against individual risks. An attractive feature of the GBL is that it acknowledges the inability of the individual borrowers to cater to the collateral requirements. In place of collateral, the GBL substitutes joint liability of the group member. According to Tassel (1999), the joint liability, feature of the GBL approach, makes each individual mutually liable for the entire group’s repayment obligations. Karlan (2007) states that direct evidence that group members with better social connections have better knowledge of each other and are more likely to punish defaulters by cutting relationships, suggesting that peers in these groups know how to discriminate between guilty on the one side and bad luck on the other. Since the poor masses targeted by group lending schemes have little or no credit history in addition to their inability to provide collateral requirements for backing up their loans. In view of this problem the lending institutions have to rely upon other sources to sort clients especially when initiating credit operating in remote rural areas. The microfinance Institutions try to exploit the information of local village money lenders which are well-informed about the individual seeking loans. Through the GBL approach the Microfinance Institutions tend to cater to the problems arising due to asymmetric information. Bebczuk (2003) states,

“Asymmetric information in a financial contract occurs whenever the lender lacks the necessary information and control on the borrower’s ability and willingness to repay her debt” (pp. xi).

This is where the GBL approach can play a vital role. Through this approach, the lending institutions seek to minimize the problems arising due to information asymmetry. GBL acknowledges the members of the group to eliminate the asymmetric information between the borrowers and MFI’s. The high repayment rates in GBL have solved the problems of asymmetric information (Chatterjee et al. 2005). Group members promote the repayments even in the absence of collateral by monitoring each other and helping the MFI’s in excluding the risky borrowers. According to Bolton et al. (2005), MFI’s took an advantage of this
limited access of credit to create repayment incentives despite of poor entrepreneurs’ lack of collateral. The GBL approach enables the MFIs to utilize the joint liability as well as the knowledge of members in a group in order to minimize the non-repayment risks. Ghatak (1999) states that under joint liability, a single borrower’s terms of repayment is made conditional on the repayment performance of other borrowers in a pre-specified and self-selected group of borrowers. The salient feature of GBL is the formation of the groups of borrowers. The formation and continuation of the group got serious concerns (Dorfman et al. 1988) and challenging as well because the members of the groups can be homogeneous or heterogeneous by their gender, occupation, age, income, education, etc. The population living in the rural areas of the region is most commonly in the practice of making homogeneous groups in this regard considered as a solid reason of high repayment rates. Grootaert et al. (2002) claims that homogeneity of groups are by and large made in terms of villages, gender, land holding status and income levels and has proved to be an important element in the growth of repayment rates. Huppi et al. (1990) believes that while making loans under GBL to homogeneous groups of borrowers belonging to the same rural community and with alike fiscal status have tended to be more successful than others. Whereas Grootaert et al. (2002) states that homogeneous and heterogeneous are not extensively different. He proposes that the possibility of acquiring peer support is higher in a heterogeneous group. The present study will revolve around the effect of group formation, while applying GBL approach in MFIs, under the risk of non-repayment. Developing a comprehensive literature and identifying a strong impact of group formation on the non-repayment risk of MFIs seems an important research for future concerns.

1.3. RESEARCH PURPOSE

The purpose of this study is to analyze how MFIs are managing their non-repayment risk by using GBL approach.
1.4. RATIONALE

Indeed, MFIs were made on the promise of removing poverty and uplifting the living standards of the poor people by giving the loans to them especially in the rural areas. As per Singh (2007) the main aim of the MFIs are more than be a lending institutions and these were made to help in breaking the vicious circle of poverty in long term. But still in order to work on the basis of long-term plan, a MFI need to monitor the threats those are going to challenge it sooner or later. And the main threat, in this regard, is the failure of repayment from the borrowers. Based on the discussion above in background, problem discussion and as per the purpose of this study, I am trying to investigate that how the MFIs are shaping its policies and negotiating with the upcoming threats of non-repayment of funds from the borrowers with the help of GBL.

1.5. RESEARCH QUESTION

Relating to the above discussion and to reach the purpose of this study, I formulated the following question:

*How is the group formation done in MFIs using Group-Based Lending approach to manage non-repayment risk?*

1.6. STRUCTURE OF THE THESIS

I have split my study into six chapters that would acknowledge not merely reader to understand but also me (author) to write the thesis in a discovery mode. The chapters would assist in understanding the subject matter step-by-step. These chapters will definitely be written by keeping the fair hierarchy of the topic in mind. The structure of the thesis will show the highlight of the whole thesis and here, I tried to give reader the glimpses of the each chapter discretely.
Chapter 1: Introduction

In this chapter, I have discussed the background of the microfinance which leads to the evolution of the MFIs. I defined the MFIs and its mode of lending. I spotlighted the GBL because it is widely used all around the globe and helps in removing the asymmetric information between the borrowers and MFIs. Group formation is the important attribute of GBL; the focal point of my study would be the impact of this attribute on non-repayment risk. I developed a purpose of my study in this regard and made a question in order to achieve that purpose.

Chapter 2: Research & Methodology

I will talk about the approach which I am going to use which can help me in reach my purpose and entertain the question which I mentioned in the Introduction Chapter. I will mention that I have planned to implement a case study strategy for my study. I would enlighten the subject MFI of my report which is Khushhali Bank Limited, Pakistan and how I would do the data analysis after gathering primary and secondary data of that MFI.

Chapter 3: Theoretical Framework

Here, I would have a detailed theoretical examination of the concepts of micro financing and the GBL. I am going to make four theories as the base of my namely Portfolio, Principal-Agent, Contract and Transaction Cost Theories with the intention of having a deeper look inside the relationship between the lender and the borrower. I would explore that how these theories fully or partially can be helpful for the MFIs to remove or at least decrease the danger of non-repayment.
Chapter 4: Case Study of Khushhali Bank Limited, Pakistan

In this chapter, I would give you a slight idea about the country of the subject MFI (KBL) then I would have a presentation of whole the data (secondary & primary) gathered by myself about my KBL. I would manage to conduct two interviews for the sake of primary data and will demonstrate the findings of those interviews as well.

Chapter 5: Analysis

In this part of study, I would analyze the information, gathered by the secondary data and the findings from the interviews which I will conduct with the purpose of collecting primary data. The theories, which I would discuss in the theoretical framework of the study, would be the parameter of the research and will enable me to judge the information gathered from the subject MFI (KBL).

Chapter 6: Conclusion

In this chapter, I will give a conclusion of my study on the basis on the research work done during the study which will facilitate me in answering my research question. Later, I shall give the implications of my research to the MFI's according to the conclusions. I would like to describe the limitations of my study in this chapter and finally would be pleased to leave suggestions for the further research in this regard.
Chapter 2

RESEARCH & METHODOLOGY

The choice of methodology to use would be affected by the selection of field to study. In this chapter, my focus is on describing in detail about the processes adopted in order to reach the purpose of the study and to answer the research question stated in first chapter of Introduction. Fisher (2004) notifies that due to essential role of relationship among theories, practice, knowledge and actions, there is a difference between research in management business and other research fields. So here in this part of the study, I would go over the main points of my work from commencement to ending.

2.1. RESEARCH APPROACH

Research without strategy is like a soldier planning a war without a plan. Every research needs a strategy by the person who is going to make a research in his/her subject field. Bryman (2004) splits the approaches into two camps which are most commonly used in the research as follows:

- Deductive Approach
- Inductive Approach

The empirical data is making a distinction among them. In inductive approach, the researchers collect the empirical data first so that they could know that either the selected topic of research got an adequate margin of findings or not. On the other hand, in deductive approach, researchers take the concept of the theory first and then validate it by getting the empirical data in the end of the research. In my study, Deductive Approach is being used in order to reach the purpose of my study. I shall discuss some interrelated theories in the Chapter 3; Theoretical Framework which would support in understanding the study.
purpose as well as will help me out in answering the research question after conducting the detailed analysis of the empirical findings from my subject MFI (KBL) those will facilitate me in validating them from the literature.

2.2. CASE STUDY RESEARCH

There are numerous research strategies to adopt for accomplishing the target of our study such as surveys, grounded theory, case study, action research and ethnography. Saunders et al. (2003) states that researchers must use the research strategy which could help them out to entertain the research question in the best possible way. I am going to study Khushhali Bank Limited, Pakistan (Henceforth KBL) as the case study of my dissertation. In order to accomplish the purpose of my study and to answer the research question (formulated in 1st chapter: Introduction), I found this bank the best suited sample for my study regarding group formation under GBL for non-repayment risk. The reasons of selecting the KBL among other MFIs are as follows:

- First, all the KBL loan schemes are based on GBL.
- Second, the pivot point of the all social and financial services, rendered by the bank, is the community organizations.
- Thirdly, the bank is not depending on its community organizations in order to form the groups of borrowers

2.2.1. Khushhali Bank Limited, PAKISTAN

Khushhali Bank Ltd. Pakistan was made by the Govt. of Pakistan in year 2000 under the part of Poverty Reduction & Rural Development Strategy. KBL is trying to go to the poor households in the rural areas as 80% of the Pakistan’s population is living there. It is making it possible by exploiting the local community small organizations. They help the bank to reach at
the door step of the poor. KBL is using Group-based lending in its all loan schemes under microfinance lending. KBL (2004) states,

“Group formation is a direct approach being used by MFIs having clear focus on the objectives of the Microfinance Institution (MFI) delivering microfinance services. This approach is called “Group Based Lending” or lending to “Self Help Groups” (pp. 19).

Group lending helps in increasing the re-payment of loans by creating the pressure among the group members to work hard in order to compete each other. This passion by the group members shows the effectiveness of group lending, that it reduces the risk for the bank to collect the money. Group lending is based on the guarantees of the group members for each other to the bank. Means every group member pays the guarantee of another to pay back the loan within schedule timetable. So, each group member is legally responsible to pay back the financial liability of the bank and the guarantee is extended from individual borrower to the group borrowers.

2.3. DATA ANALYSIS

In this dissertation, the case study method is being employed to examine how group formation can be used as an effective non-repayment risk tool by MFIs under GBL. According to Yin ‘case studies are the preferred strategy when ‘how’ or ‘why’ questions are being posed’ (Yin, 2003, p.1).

This study that I tend to undertake shall involve an analysis of academic literature about group formation to manage non-repayment risk by MFIs through the GBL. The articles selected in this regard are peer reviewed articles selected to meet several criteria. The goal is to broaden my understanding about
the group formation under GBL and to achieve awareness regarding a wide range of opinions, data and different points of view. Another useful resource is been books about the topic. A case study which is often connected with descriptive, explanatory or exploratory research fits perfectly to this research design (Yin, 2003).

To give my thesis a more pragmatic point of view, I viewed as to how the group formation is being done in homogeneity and heterogeneity orders. This certainly helped me in acknowledging the utility of GBL in a real life scenario. This single case study approach is selected carefully. Ghauri et al. (2005) write:

The time available for the study, financial resources for travelling and other practical issues are great importance. For example, depending upon how much time we have to study, the type of organization or company we select for our study would be different. If we have very little time available, we should perhaps study a smaller firm, as in these firms the communication lines are smaller and faster, they are more flexible and it is easier to get overall or in-depth information. (pp. 118)

2.4. RESEARCH DATA

In this analysis, I will adopt the use of peer reviewed articles, for getting a broader range of different positions and diverse ideas. Getting so many opinions would be nearly impossible with just primary sources as due to time factor, distance from the locations and accessibility of the key persons due to their busy schedules. Any benefit to my data gathering is that there is a sufficient amount of data regarding my research topic is available.
2.4.1. Secondary Data

I shall gather data from unlike sources like for books I would prefer Google books, Electronic Library and my campus library and for Journals, Surveys, Dissertations and Publications etc., I would prefer try searching on Google Scholar. Hussey, J. et al. (1997) tells that “This is the data which already exists”. It is the data which is handy and by far accessible information to solve the research problems as it is pre-posted research & information. With the help of this secondary data, I would be able to manage the awareness of the problem and it will enable me to chalk out the results and achieve the purpose of my research. And as the technology progressing, this secondary data is becoming more and more useful in not merely mine but any research study. Especially, if you get inadequate knowledge or studies regarding your topic in your own destination then just because of technology, you can get all material from internet like I mentioned electronic library and other electronic publications above.

2.4.2. Primary Data

Numerous choices are available regarding primary data collection. Ghauri et al. (2005) states,

“That there are some advantages and disadvantages of primary data like long time and cost involved; further difficulties in getting access to respondents, careful application of tools and methodology for analysis, and at last the quality of information can be affected due to the ability of respondents”.

In order to get a practical knowledge about my concept, my work also benefit from a company as a primary source. I will formulate some structured & unstructured questions in order to gather the information, I
need in this regard. The information from that MFI will achieve through email and telephonic interviews. I will conduct telephonic interviews in order to get the information about the matter from KBL officials. All the contact information of the bank is available on its website. Either, there is no contact information about the board of directors of the bank but I will try to make a link with the bank officials to get adequate information from them which would quite handsomely helpful for my research study.

2.4.2.1. Interview

Interview is a discussion on a specific topic among two or more people where questions are asked by the interviewer to take the information from the interviewee. In my study after collecting the secondary data, I will switch towards the primary data collection and for this cause; I have decided to conduct the telephonic interviews as my subjected MFI (Khushhali Bank Limited, Pakistan) is working in Pakistan only and I cannot go there to conduct interview personally while I’m studying here in Sweden.

2.4.2.2. Purpose of the Interviews

In order to get the primary data, I am intended to conduct two interviews from the KBL officials with the purpose of getting the idea of the bank’s basic structure and to look into the working of its policies and programs either they are supporting good enough to meet the MFIs requirements and helping the bank to survive well against the recovery threats or the bank is facing the difficulties in the market environment.
2.4.2.3. **Interviewees’ Selection**

Initially, I found terribly hard to get a time from the managers because they are too far in Pakistan from my approach and to get them on the line for the telephonic interview, being here in Sweden, was a tough job. But finally, I managed to arrange two KBL officials for conducting interviews telephonically namely Mr. Anwar Shakeel & Mr. Zahid Rafique.

- Mr. Anwar Shakeel is 35 years old and working for KBL since 8 years. He is a Branch Manager. He has also worked for United Bank Limited; Pakistan which is a prominent one in Pakistan’s banking industry.

- Mr. Zahid Rafique is 39 years old and serving KBL since the bank was founded. He is working there as a Credit Control Manager.
Chapter 3

THEORETICAL FRAMEWORK

In this chapter, I shall describe diverse theories which has been studying and assessing in the previous researches regarding the research topic. I shall also discuss different theories, later this chapter, supporting the significance of group formation in the GBL and how the formation of groups are contributing in downsizing the proportion of non-repayment risk under the head of Micro financing.

3.1. MICROFINANCE

According to Castiglione et al. (2008) “The term ‘Microfinance’ refers to all financial services (loans and/or savings) provided by programmes, non-governmental organizations (NGOs), or even banks to assist low-income people who are economically active, yet have no access to commercial banks” (pp. 470). Ledgerwood (1999) states Microfinance is the provision of financial services to low-income households, including the self-employed. Adding up to financial intermediation, some MFI’s also provide social intermediation services, including help in group formation and the development of self-confidence, financial literacy, and other services. Dror et al. (2002) defines that MF involves a range of financial services, even if loans have been the de facto focus of many MFI’s. The provision of deposit-taking facilities, payment services, remittances, leasing, and insurance are part of micro-finance. The Small Industrial Bank of India (2000) states that microfinance as provision of financial services delivery to poor women, at their door steps, in a sustainable and profitable manner, which includes loans, savings and insurance products, on time, in user friendly manner at affordable cost to the clients, reaching out in large number of people formed in
groups or severally consisting of small value products (sited in Singh 2007). Schreiner et al. (2001) define microfinance as “the attempt to improve access to small deposits and small loans for poor households neglected by banks” (pp.339). In my study, the following definition of microfinance would be considered as the base in this regard; According to Asian Development Bank (2000),

“Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their microenterprises”.

Therefore, microfinance consists of the financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector. Robinson states that the 1980s represented a turning point in the history of microfinance in that MFIs such as Grameen Bank\(^1\) and BRI\(^2\) began to show that they could provide small loans and savings services profitably on a large scale.

**Figure: 3.1 a Difference between MICROFINANCE & MICROCREDIT**

Both terms are often used interchangeably but it is important to highlight the difference between them because both terms are often confused. Indeed both terms are relevant to the small loans to the people but Microfinance is like a broad term of Microcredit. Berger et al. (2006) distinct between two terms that either both terms refer to small transactions, but Microcredit deals with the lending side of financial operations only while Microfinance refers to an entire series of financial services like micro-savings, transfer of remittances and micro-insurance including microcredit.

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\(^1\) Grameen Bank (GB), Bangladesh  
\(^2\) Bank Raykat Indonesia
They received no continuing subsidies, were commercially funded and fully sustainable, and could attain wide outreach to clients (Robinson 2001). The 1990s “saw accelerated growth in the number of MFIs created and an increased emphasis on reaching scale” (Robinson, 2001, pp.54). Hardy et al. (2003) states that MFIs has accelerated their expansion in many parts of the world in last more than two decades. MFIs are managed to maintain large number of clients, important loan portfolio and hold a significant share of financial assets of poorer people (Hardy et al. 2003). Microfinance has now turned into an industry (Robinson, 2001). According to Cull et al. (2008), MFIs have proved the prospect of making available a trustworthy banking services to poor customers; by serving nearly 5 million households worldwide today (Abbink et al. 2006). Narayan-Parker & Narayan (2002) stimulate that in these previous years of microfinance lending are that poor people can borrow and repay on commercial terms and that poor people have far above the ground demand for suitable saving tools. No matter how well the lending to poor was going but still poor were unable to secure themselves from the risk of non-repayment (Udry 1990). These threats and insecurity made the targets clear in the minds of governments and practioners to provide safety nets to mitigate the blows and safeguard poor’s chances to get better the things in their life; that targets leads the practioners towards one of the most significant innovation namely GBL (Meier & Stiglitz 2001).

3.2. GROUP-BASED LENDING

The successful repayment rates of the programs like Grameen Bank and the Bancosol turned out to be the parameters to measure the success of GBL. This shows that these institutions have been recognized to get a hold on removing or blocking the asymmetries in the information that leads to the high repayment risk. Most of the literature while talking about the GBL normally gives this high repayment risk credit to the salient feature of this approach that is program
screening inside the group members to generate pressure among them in order to pay the joint liabilities. I concentrate here to discuss the GBL and its working performance in the other researchers’ point of view like Armendariz de Aghion et al. (2000) explains GBL refers to the practice of working with clients in small groups. Loans are made to individuals, but the group as a whole responsible to repay the debt if repayment difficulties arise. Conning (2000) defines that GBL is renowned as a contractual modernism that has achieved the noticeable vision of enabling marginalized borrowers to lift themselves up by their own bootstraps by creating ‘social collateral’ to replace the missing physical collateral that excluded them from access to more conventional forms of finance. Narayan-Parker & Narayan (2002) states that it allows the poor to employ their social capital as a collateralizable asset decrease the both risk of non repayment and transaction costs to the MFIs and facilitate poor to triumph over their lack of material collateral and involve in shared learning. Meier (2005) expresses that due to the better information of each other in a group than MFIs, GBL works effectively and information-sharing role of social capital and the peer pressure allow the poor to trounce the barrier on their access to credit. Narayan-Parker & Narayan (2002) points out that in case of reaching the poor especially the poorest then the groups can play a significant part in reaching them because they make the base on which other institutional system depend. Group loans are more likely to be repaid (Armendariz de Aghion & Morduch, 2005). Morduch (1999) describes that GBL helps in maintaining the high-repayment rates by using dynamic incentives, regular schedules of repayment and collateral substitutes. According to Narayan-Parker & Narayan (2002) numerous benefits of innovations in financial feasibility credited to GBL that includes persistent repayment in small loans; incentive-based innovations to wipe away the asymmetries in information consists of small, interim loans and building up the size over time for those with a good track record of repayment and needing a specific amount of savings to set up the client’s assurance and capacity to repay a loan. Meier & Stiglitz (2001) insists that
group of poor can join together for the sake of loans and have a check on each other to ensure the repayment as they know each other quite a lot and got so many chances to interact and enforce their social expectations from each other that also head towards the decrease in enforcement of repayment and the collecting information costs considerably by GBL. Originally the idea behind in GBL is that to remove or at least make it lesser than ever the poor’s lack of confidence of not repaying the loan and the weaknesses at the individual level by sharing his/her liability and making a ideal formation of group of such individuals (sited in GB’s website). Ghatak (1999) adds that it provides a way to price differentiate that is impossible in an individual-lending. In order to view the working and aspects of GBL on the borrower and the lender sides, I am going to take the four theories into account namely:

- Portfolio Theory
- Principal-Agent Theory
- Contract Theory
- Transaction Cost Theory

These above mentioned theories will help me in conceptualizing the situation between the borrower and the lender. The portfolio theory will be useful in estimating the risk from the lender’s point of view while the Principal-Agent theory will cover the whole relationship between the borrower and the lender during the time of the agreement. Contract Theory will enlighten enforcement of the terms and conditions which are mutually agreed by both the parties. And in the end, Transaction Cost theory will enable me to understand not merely the circumstances of terms of borrower and lender at the time of getting into a relation of exchanging goods or services but also the factors effecting the that relation even before coming under an agreement. I would discuss the parts of these theories which is relevant and would assist me in fulfilling the purpose of
my study. These theories will assist me in understanding the conditions faced by the lenders and borrowers when they are in the process of lending and how the effects of these theories can be helpful in minimizing the risk of non-repayment. Moreover, they will facilitate me in answering the research question in a convincing manner and also will make this easy for me to value how they deal with the problems/hurdles in the relationship of borrower and the lender.

3.3. PORTFOLIO THEORY

As the group formation process in GBL is inspired by the portfolio theory so I found the portfolio theory better among the best to set this theory as the parameter of my study on which I would be able to analyze the performance of MFIs in this regard. Portfolio Theory by Harry M. Markowitz, spotlight on the construction and selection of optimal portfolios of risky assets by risk-averse investors (Rabin, 2003). Cunningham (2002) describes the central idea of the theory is that merging a group of non-correlated stocks in a single portfolio ends up with a portfolio with less instability than the average instability of those individual stocks. Rabin (2003) states that the theory based on a mean-variance optimization process that looks for efficient portfolios and an efficient portfolio is that gives minimum risk for a specified level of return or maximum return for a specified level of risk. Saunders & Allen (2002) explains that mean (return) and risk of a portfolio of assets, under the assumption that returns on individual assets are usually disseminated. Elton & Gruber (1999) explicate that the theory formulated the portfolio problem as a selection of the mean and variance of a portfolio of assets that validated the primary theorem of mean variance portfolio theory namely holding constant variance, enhancing anticipated return and holding constant expected return minimize variance. Alavalapati & Mercer (2004) stated that in the perspective of decreasing the risks in the financial portfolios, this theory defines the concept of diversification thoroughly.
3.3.1. Risk Diversification

“Diversify means, Don’t Put All Your Eggs in One Basket” (Shim et al., 2008). Diversification is important in reducing risk (Booth et al., 1999). MacLeary & Nanthakumaran (1988) states diversification refers to the risks involved by investigating the profiles and character of the assets to be considered for investment by the portfolio investors. Neave (1991) states that theory emphasizes on having a diversification in the portfolios which heads towards minimizing its risks by offering given expected rate of return. Sayce et al. (2006) explains that these risks relating to the expected return and the range of expected returns measured in terms of variance or standard deviations and this standard deviation (risk profile) of the portfolio can be reduced by uniting the investments. Ogilvie & CIMA¹ (2007) divides the risks in two elements namely:

- Specific Risk / Unsystematic Risk
- Market Risk / Systematic Risk

![Figure: 3.3 a Risk Reduction through Diversification (Ogilvie & CIMA, 2007)](image)

Market Risk cannot be decreased by diversification (Ogilvie & CIMA, 2007) because it’s an inherent risk in the market and exists without regard to selection of specific assets (Lush et al., 2003). They arise from the

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¹ Chartered Institute of Management Accountants
outside forces of the firm and therefore not unique to the given security (Shim et al., 2008). Whereas, diminishing of Specific/Unsystematic Risk is the fundamental aim of risk diversification (Jessup & Upson, 1973). Ross et al. (2004) discuss the relationship between the returns of two assets/stocks. He elaborates that the vice versa returns of two stocks show a negative relationship between the both returns and that negative relationship between the two returns gives a boost to a negative value of covariance. In the following matrix, you can see the example of negative relation of two un-interrelated portfolios:

<table>
<thead>
<tr>
<th>Figure 3.3 b</th>
<th>IKEA</th>
<th>VOLVO</th>
</tr>
</thead>
<tbody>
<tr>
<td>IKEA</td>
<td>Less Value</td>
<td>High Value</td>
</tr>
<tr>
<td>VOLVO</td>
<td>High Value</td>
<td>Less Value</td>
</tr>
</tbody>
</table>

In the above figure, when IKEA’s value decreases the Volvo’s value will increases and vice versa so this is how the risk of whole portfolio gets down. The most highlighted thing in this regard is that both the portfolios are not inter-related to each other. And these un-related portfolios, that exhibit low or negative covariance, lead to removal of the unsystematic risk.
In the figure 3.3c, it is clear that as the degree of diversification increases; the non-market (un-systematic) risk starts diminishing and heads towards its elimination but the market risk is constant as PT has no impact on it. Diversification under the PT leaves the systematic risk as persistent and benefited as the reduction in the non-systematic risk (Sayce et al., 2006). Rabin (2003) states that diversification needs the selection of securities based upon their interrelationships or co-movements, not just a random selection of a large number of securities.

### 3.4. PRINCIPAL-AGENT THEORY

I selected principal-agent theory (PAT) because I would be in capacity to judge the relationship between the principal (lender) and the agent (borrower). As I find this theory preeminent in describing the contract of principal-agent which plays a vital role in removing all kind of misunderstandings between them. Also it deals
with the most important part of lending that is the recognition and the selection of the genuine borrower. Eisenhardt (1989) explains this theory that can be related to employer-employee, lawyer-client, buyer-supplier and other agency relationships; its paradigm engages careful specification of hypothesis which is followed by logical subtraction and mathematical proof. Bruhn (2003) defines PAT that talk about the uncertainty and asymmetric information in the subject of socio-economic relationships. Spulber (2002) states “principal-agent relationship refers to a contract in which one party, the principal, delegates responsibility to carry out a task to the other party, the agent”. Bauer (2001) says about the PAT is that the theory deals in establishing a contract with a common response to resource dependency. The relationship party with greater dependence on the opposing party is Contract issuer (Principal), while the opposing party represents the agent (Bruhn, 2003). And the theory is based on this hypothesis that both the parties (Principal & Agent) have the different and unaligned interests (Vegas & World Bank, 2005). Hawkins et al. (2006) enlightens the theory that it deals about the controlling techniques of the theory including monitoring, reporting requirements, screening and selection procedures those benefit a lot to the principal to remove asymmetry in the information. Brehm & Gates (2008) points out “the essence of the principal-agent problem is asymmetric information, such that the abilities and preferences of the agent are unknown (adverse selection), and the actions of the agent not entirely observable (moral hazard)”. Spulber (1999) adds that moral hazard and adverse selection are the fundamental inefficiencies of the agency relationships. I am defining these two concepts to be understood which come under the umbrella of Asymmetric Information. These are as follows:
3.4.1. Information Asymmetry

According to Low (2000), chances of asymmetric information in between principal-agent relation are too much because agent always knows information than principal to accomplish his/her assignment. In case of hiding any information, the agent leaves principal in an imperfect situation that gives a space to adverse selection behavior and moral hazards.

3.4.1.1. Adverse Selection in PAT

Brehm & Gates (2008) defines that this term comes from the insurance literature which deals with one problem for the company which of the individuals might purchase insurance policy just in order to get a claim. Clarke (2004) states adverse selection deals with the misrepresentation of proficiency by the agent. Spulber (1999) states that adverse selection or asymmetric information, take place for the reason that of the costs of observing the agent’s concealed information like the agent’s productivity or cost of effort. Clarke (2004) states that adverse selection raises its head when the principal is not able to verify skills of agent fully either at the time of hiring or while the agent is working; this happens when the agent may claim to have certain abilities when he/she is hired.

3.4.1.2. Moral Hazards in PAT

Spulber (1999) defines that moral hazards happens since the costs of monitoring the effort that the agent put in a productive task and the contracts that make efficient act would engage costly switching of risk to the agent just because of moral hazards are not fully removed. Demski et al. (2006) states moral hazards in this agency theory arise due to two individuals’ differing preferences, information, assets rights and skills. The term moral hazard is considered as the problem of agent shirks
(Spulber, 2002). Bolton & Dewatripont (2005) states the principal agent problems with the moral hazard have been broadly used as a representation of different standard economic relations.

### 3.5. CONTRACT THEORY

The beginning of a relationship of exchanging goods or services based on the consent of the parties involved in. According to Chiappori & Salanie (1997) contract theory describes the relationship between some parties those are looking for their collaboration to reach some goals. The parties made an agreement in this regard to follow the proceedings after the consents. Contract theory valued the significance of that agreement or contract between the parties. Tatum (viewed in website at June 2009) narrates that contract theory revolves around the need for communication among an agent and a principal, so that there is clear understanding of both the needs of the principal and the ability of the agent to meet those needs in a competent way. DiMatteo (1998) explicates that the theory investigates the logical and theoretical structures that raise their heads in the process of making, honoring and in the enforcement of the contract. This theory has a very strong relation with the Principal-Agent Theory because the relationship between the principal and the agent can only be arranged with the help of any agreement or contract and the contract theory encourages not merely the factors those can affect the relationship between both parties but also seeks for the additional factors those validate the legal enforcement of a commitment or promise given by the agent to the principal.

### 3.6. TRANSACTION COST THEORY

Business activities base on multiple objects but here I am going to discuss the transaction which is being considered one of the most important factors among all business procedures. According to Brousseau & Glachant (2002) transaction
cost theory (Henceforth TCT) studies the possibility of separating or integrating various components depending on their asset specificity. Transaction is liked to be an agreed exchange or transfer of goods or services (Rabin, 2003). And this transfer of goods or services has never been without incurring any cost on it. This cost consists of an agreement which smooth the progress of such transfer (Rabin, 2003) and that transfer of goods or services takes place in the market instead of within the organization. Williamson (1985) states that the transaction cost refers to the effort, time, and expense involved in obtaining the information necessary to negotiate, make and enforce an exchange. Transaction cost also includes the costs of searching for new suppliers or customers, negotiating, writing contracts, monitoring the other party’s activities and enforcing the contract (Beamish & Killing, 1997). By avoiding internal differences and raising the notion of asymmetry in information, the theory established itself as a successful one (Sokolowski 2001). TCT emphasizes the significance of the institutions foundation exchange relationships those are markets, contracts and firms that is why it seeks to create a distinction among the properties of transactions with the intention of identifying which institution is the best among others (Rabin, 2003).
Chapter 4

CASE STUDY OF KHUSHHALI BANK LIMITED, PAKISTAN

In this chapter, the overview of the environment of micro financing is being discussed by providing the initial information regarding the country of subjected MFI. The information about the Khushhali Bank Limited, Pakistan (subjected MFI) has been taken by the official website, reports and the telephonic interviews of the managers in this regard. Moreover, it sketches out the present situation of the case as perceived by me by having a look over the MFI's personal goals and missions.

4.1. OVERVIEW OF PAKISTAN

Pakistan is among the largest populated countries in the South Asia with the population of 163.9 million (UN\textsuperscript{1} 2007). It is spread over the area of 796,095 square kilometers (ESCAP\textsuperscript{2} 1997). Regardless of the geographical surroundings of the country, the economy of Pakistan is portrayed by the predominance of the agricultural sector. It is anticipated that of 6.5 million poor people who need microfinance services in Pakistan, only about 5% are being served by MFIs (Setboonsarng \textit{et al.} 2008). The Financing sector in Pakistan has been going through a comprehensive but complex and painful process of restructuring. It is aimed at making the institutions financially sound and forging their links firmly with the real sector for promotion of savings, investment and growth. Although a complete turnaround in banking sector performance is not expected till the completion of reforms, signs of

\begin{itemize}
\item United Nations
\item Economic And Social Commission For Asia And The Pacific
\end{itemize}
improvement are visible. The almost simultaneous nature of various factors makes it difficult to unknot signs of improvement and deterioration. Whereas a decline in repayment ability of borrowers may increase provisioning but the situation is expected to improve in next years.

4.2. KHUSHHALI BANK LIMITED, PAKISTAN

Khushhalii Bank Limited (Henceforth KBL) was founded in year 2000 and was a part of the Government of Islamic Republic of Pakistan's Poverty Reduction Strategy and its Microfinance Sector Development Program (Henceforth MSDP). Its establishment was come into being with the initial capital of PKR 1.7 billion by the joint venture of 16 banks, 12 private, 2 state-owned commercial banks and 2 foreign banks. KBL operates as the benchmark representative of the banking and microfinance sectors’ cooperation. Operating as a microfinance bank itself, it lends directly to low-income clients and also to microfinance practitioners operating throughout Pakistan. MSDP was developed with the facilitation of Asian Development Bank (Henceforth ADB). The directive leaves to retail microfinance services and to act as a medium in becoming constantly the country's newly formed microfinance sector. KBL defines it mission as,

“To strengthen the economic base of low-income populace across Pakistan by improving their accessibility towards financial services. By supporting a diverse product suite with exemplary customer service, and by combining cost-efficiency with next-generation delivery systems, we intend

\[1\] Pakistani Rupee
achieving our core objective of operational and financial self-sufficiency.”

KBL is working on the values of service excellence, performance, ethics, teamwork and professionalism. KBL is being operated under the Microfinance Sector Development Program (Henceforth MSDP) which was initiated by the Government of Pakistan through a Microfinance Development Policy. MSDP has an important objective – to provide affordable financial and social services to the poor, for a significant impact on poverty reduction through:

- Increased revenue of poor households
- Enhanced outreach mainly to women
- Increase social Capital
- Decreased risks faced by poor

The MSDP offers an incorporated package of policy reforms and most advantageous funds for institutional growth, with the purpose of outreaching development to smooth the progress of expansion of the microfinance sector. KBL is operating in all provinces of the country, while its main concentration is in rural areas. It works in all 4 provinces including Azad Jammu Kashmir (AJK) & FATA through a network of 113 branches in six regions:

- 22 branches are in Peshawar (North West Frontier Province, NWFP)
- 12 branches are in Rawalpindi (Punjab Province)
- 21 branches are in Lahore (Punjab Province)
- 21 branches are in Multan (Punjab Province)
- 21 branches are in Quetta (Balochistan Province)
4.3. FINDINGS OF THE INTERVIEWS

By conducting the two telephonic interviews of the KBL managers, I have managed to get the passable information which would be quite ready to lend a hand in answering my research question and understanding the practices of the bank as a MFI. KBL has become the largest MFI of the Pakistan till today by having 113 branches in the four provinces of the whole country. KBL got more or less 25 employees working in every branch. Bank is putting its so much effort to focusing equally in all parts of the country but as the bank is always keen to provide the loan to the people who might does not have any access to the bank or cannot get the loan from other commercial banks due to collateral or any other reasons, that attitude ended in focusing on the population living in the rural areas or bit away from cities. Because these people neither have a lot of banks in their surroundings nor they have the collateral to get a loan. KBL is not making only women the center of attention for lending like Grameen Bank, Bangladesh but it is spotlighting equally on males and females in the population.

4.3.1. Assessment of Borrowers

KBL has Customer Sales Officers (Henceforth CSO) who are responsible to educate the people about the bank’s products and services in the areas where the people are really in need of money. And when any individual applies for the loan to the bank then CSO analyses the application on the basis of the incomes and expenditures of the borrowers by having a detailed analysis of the cash flow which covers all kind of incomes daily, weekly, monthly, quarterly or annually. Secondly, all the incomes of the group members should be positive if they want to be eligible for the loan. If the any individual in the group gain minimum numbers to get the loan
from the analysis then the other group members give the guarantee of each other in that group. After the approval of loan from CSO, the credit control manager steps in to check the application and asks for the further requirement if needed. Moreover, as being the state owned bank, KBL has the access to the data of National Database and Registration Authority, Pakistan\(^1\) to verify the information provided by the applicants for the loan and does not depend only on the inspection of its Business Development Officers. Besides, KBL is also using the services of many Community Organizations whose mobile units used to travel on a regular schedule to the rural areas at their door step. These organizations are the central point for delivering social and financial services for the KBL by consisting of more than 4000 members.

### 4.3.2. Group-Based Lending (GBL)

From the beginning, KBL is using the GBL approach as the Grameen Bank’s repayment ratios through GBL had impressed all the economists and practitioners. Besides, the majority of the population of Pakistan is also not in a position to provide any collateral against the loans like Bangladesh that’s why KBL has never switched to the individual lending. The best thing considered by KBL by using GBL approach is that this is the way where the bank can approach many people at once. While in the individual lending method, MFIs have to go to each and every person one by one and entertain him/her needs and requirements. GBL has been enabling the KBL to increase the disbursements among the people and provide the opportunity for maximum introduction of the products and services provided by it. Creating a pressure among the group of borrowers to struggle a lot more than they do normally, to vie the

\(^1\) NADRA – National Database and Registration Authority [www.nadra.gov.pk](http://www.nadra.gov.pk)
members in the group, becomes the key of getting a higher rate of return for the bank.

4.3.3. Group Formation

As I mentioned above that CSO is responsible to find the individuals who are in a need of loan, when an individual comes to get a loan then it’s CSO who formulates the group for that individual on the basis of the conditions given by the bank that the borrowers must be located in the same area and must know each other very well if they want to be a member of the same group of borrowers. And if the CSO finds himself/herself nowhere to give that individual a company in the group for loan then CSO can say the customer to find a group member for him to get a loan as per the bank’s terms. Moreover, KBL restricts the borrowers in the certain range of groups like the maximum group size cannot exceed 20 members and the minimum group size in rural areas cannot be less than 8 members and the minimum group size in urban areas cannot be less 3 members. Similarly maximum personal guarantee (PG) size cannot be exceed ten and minimum PG size in rural areas cannot be less than five. Even by knowing that in the GBL, members of the group normally monitor each other’s activities still KBL sends its Business Development Officers (BDO) to the localities to check the progress of the members whether they are performing their activities as per their contract or not. And if they are not performing their roles as per their deal or if the bank feels that the way, members are doing the work, will not be succeeded in paying back the loan then bank takes the initiative to help them out and to ensure its own repayment as well by re-formulating the group members. Apart from this, KBL has reserved the right to re-formulate the group at any time of the loan period.
4.3.4. Costing & Recovery of Loans

Monitoring the activities of the group of borrowers is not an easy task. Bank maintains data in these regards and pays the staff as well who visits the borrowers' localities over and over. So, bank has raised its interest on loan from 18% to 20% per annum to bear this cost. A good contract and a complete check on the actions of the borrowers have headed toward the minimization of the danger of non-repayment. KBL, while issuing the loan to the groups, gives specific dates for the installments of the loan. Each member is responsible to pay his/her installment on monthly basis. Due to this purpose, CSO has to visit three times in a month (after 10 days) to remind the payments to all group members and to be aware of the situation inside the group relevant to their businesses and relationship with each other. KBL thinks that the best advantage of having this condition is that in this situation, borrowers never feel themselves alone in any crucial conditions during running their businesses. Because majority of the people are illiterate and having no knowledge about the financial services so, it is always very beneficiary to give them a person (CSO) to guide and supervise them in this regard. With the purpose of avoiding non-repayment by the group of borrowers, CSO always tries to create an environment of competition among them to enhance the profitability of their own businesses which ultimately leads to the decrease in the probability of non-repayment of loan. While taking loan from KBL, every member of the group offers the guarantee of other borrower in the group to pay back the loan within certain time period. So, each group member is lawfully bound to pay back his/her liability of the bank. In this way, this guarantee is extended from individual borrower to the group of borrowers means in case if any member of the group of borrowers fails in paying the installments of the loan or default other members will held responsible in paying his share and according to the
bank’s terms and conditions, the CSO would be responsible in recovering the installments or the loan amount from the group as he/she has been completely in touch with all the members of the group by conducting the three visits in a month. KBL believes that by having this condition, it can improve the performance of CSOs in regard of helping and supporting the members of the group.
Chapter 5

ANALYSIS

In this chapter, I would analyze the working and strategies of my subject MFI (KBL) by considering the theories discussed in Chapter 3 (Theoretical Framework) as the parameter of my study. The motive is to build a bridge between the results of the data findings, congregate by me from the KBL, and the theories I have discussed earlier with the intention of investigating the possible impacts of these theories on the activities of the MFI.

5.1. PORTFOLIO THEORY & KBL

Risk is one of those objects which cannot be eliminated completely, one always needs to have a concern of minimizing it. Portfolio theory was given to entertain the issue of minimizing the risk. The theory talks about transforming the individual entity stocks into the groups of stocks as it believes that the portfolio after combining many individual stocks together would not be so much risky in comparison with the individual stock portfolio. And that is the same thing which is followed by KBL by adopting the GBL approach in all its lending programs to reach the maximum part of the population those are living in the rural areas of the country. This is how not merely KBL but all the MFIs is facilitating the poor households who do not have any collateral to get a loan, do not have any banking record so far or do not have any access to commercial banking system. GBL approach has been widely practiced by the many MFIs in all around the globe using the features of PT. The theory is based on the building of portfolios and the selection of the optimal ones at the same time which helps in making the task of risk minimization possible for organizations.
5.1.1. Risk Diversification & KBL

Indeed, the theory propagates the importance of making the groups of portfolios but besides, the theory underlined the importance of diversification under the roof of risk minimization. Diversification deals with the idea of selecting the individual portfolios, with the intention of putting them into a group, in a way that they must be different from each other. As the theory accepts as true that this way would lead the organization to the phase of minimization in the risk. Some MFIs do the diversification among the potential borrowers by divided them into groups on the basis of gender like the Grameen Bank, Bangladesh; it has been focusing more on women in its early days rather than focusing on the whole population. KBL has not been diversified the poor into different categories but it is on mission to serve all the deserving and needy people among the population without any distinction. As per my analysis on the basis of the theory, KBL is not even close to the idea of risk diversification. According to the interviews conducted by myself, KBL is making the diversification in the different shade by diversifying the borrowers into the groups with the help of putting a condition in getting the loan in a group that all the member of the group should know each other and located in the same area otherwise they are not eligible to get a loan in group from KBL. So, I would say that this can be condition of eligibility of getting loan in a group but one cannot call this approach of the bank as a risk diversification. KBL is taking this condition as the parameter by thinking that this would help the bank in keeping the costs down and the recovery high because by making the group of those people who live in a same area or near to each other does not only help them to monitor each other’s activities but also KBL as well when it sends its CSO to check the happenings in that particular borrowers’ group. PT also segregates the risk prevailing in the market into two branches namely
systematic/non-market and unsystematic/market risk (shown in Figure: 3.3a). Market/unsystematic risk is all the threats and pressures prevailing outside the organization and that is the reason why the risk diversification does not support in any regards to remove it from the lenders’ point of view. On the other hand, non-market/systematic risk is all about the internal dangers and threats which the company has to face or tackle in anyway and the removal of non-market risk is the fundamental aim of risk diversification. KBL is not helping itself by not having the diversification of risk in the formation of group of borrowers. As the bank has left all the responsibility on the shoulders of CSO. It always depends on CSO to visit the currents group of borrowers as well as the new borrowers. And he does not have any diversification in the groups and as long as CSO or bank would not bring diversification while making groups, the PT cannot help even in non-market risk. As it is the primary task of PT of eliminating the non-market risk because the theory has no impact outside the organization. The theory suggests that the relative increase in the portfolio diversification leads the organization where the non-market risk will be eliminated and only the market risk will be there. KBL is just thinking itself on a safe side by making the all members of the borrowers’ group legally bound to repay the loan to the bank if somebody fails to repay his/her liability. This is how the bank is diversifying the guarantee among all the members of the group.

5.2. PRINCIPAL-AGENT THEORY & KBL
Whenever the two persons or parties get involved in the completion of any task or for any other purpose, the situation between them always needed to be tackled in an organized manner otherwise the expected results cannot be achieved. P-A theory was given to fulfill the gaps between the involved parties and to avoid the occurrence of any unfavorable happenings in the relation. KBL is also paying
immense attention not merely in building a good and healthy relationship between the current borrower and itself but also making a lot of efforts in attracting the people who are not its borrower yet. P-A Theory neither deals with the motive of the two parties nor deals with that why they are joining hands together but it deals with that how they are going to accomplish the task assigned to each other according to the contract. It facilitates both the parties at the same time to understand the contents of the contract clearly. Because the theory draw attention to the targets of the both parties those are totally different from each other and needs to be clear to both of them equally. KBL, by realizing the importance of the contract, is putting its effort not only to make the contract and the condition regarding it very clear and simple but also comprehensible and straightforward so that borrower finds it really easy to understand it. As the theory stresses on maintaining a good terms between the parties, KBL is also endeavoring hard to keep the borrowers out of any stress of loan so that they would not hesitate in coming back to the bank in case of any problem or hurdle they got in paying back the loan or functioning their duties in this regards.

5.2.1. Asymmetric Information under PAT & KBL

The theory basically lends a hand in building a bridge to fill the gap among the both parties those join together under one umbrella after setting different goals and objectives to meet their own causes. The problem in filling that gap, considers as to be the reason why the theory was given, is known as asymmetric information. The reason of the being so important of asymmetry in information is that in agency relationship, doesn’t matter the parties have employee-employer, borrower-lender or any other agency relation, duo have less knowledge about each others like in case of KBL, the bank has always got a limited amount of information about its borrowers. In this context, the theory brings the possibility of adverse selection in the light through the principal’s point of view. In the
case of KBL, this is the major issue for a MFI of selecting a wrong person or the person who does not deserve the fund because the KBL like other MFIs made on the promise of helping the government in removing the poverty from the country and playing its own part in uplifting the living standards of the poor people. So, in order to avoid this condition, the bank normally uses the services provided by the community organizations because in some cases, bank finds it really hard to reach the poor people as the major part of the population is living in the rural areas. Whereas, other MFIs does not like this idea to pay an extra amount to the community organizations or any other company to reach the people or get the information of borrower. Because while paying the salaries to their own employees they do not consider it as a sane decision to get to pay further amount in this regard. It does not mean that KBL got the extra funds or it does not trust on the information gathered by its own employees but the point is that KBL knows the importance of adverse selection in a lending business. Moreover, the theory gives a weight age to recognizing the true and false from the information provided by the agent to the principal. As a lending institution, KBL is a very sensitive in taking the information provided by the borrower. KBL is following the rule of not trusting any borrower blindly. That is the reason why KBL is taking the services of the National database and Registration Authority (NADRA) which enables the bank to have a clear picture of the borrower record in its mind and also facilitate the bank to distinguish between the true and false information provided by the borrower or group of borrowers.

5.3. CONTRACT THEORY

Contract theory covers all the aspects those are interrelated among the relationship of a principal and agent. Actually this contract becomes the base of
that relationship. Both the parties are supposed to perform their duties and responsibilities according to the terms and conditions mutually defined in the contract designed by the principal. In the lending business, while discussing my subject MFI (KBL), I came to know that they are also trying hard to convey their message to the customers (current and prospective borrowers). In the application of GBL, the contract got much more importance than in other cases because here the bank needs to educate many members within the group about their own duties and responsibilities. This is quite sensitive issue because if any member in the group will not perform his task as per requirement or according to the contract then the other members within the group will be held responsible for the default member and they have to pay his amount of share on his behalf. KBL has written this condition clearly in their contracts and adding to this the bank has also mentioned in their contract that CSO is responsible to find new borrowers and if he does not find any other borrower to make a group then he/she can ask the individual borrower to find a needy person within his/her locality to make a group to get a loan from the bank. KBL has mentioned in the contract that CSO is supposed to his/her issued group of borrowers at least 3 times in a month because if any member of the group or the whole group of borrowers does not able to pay the loan then he/she is supposed to take the loan amount back from them as he gave them an approval for the loan.

5.4. TRANSACTION COST THEORY & KBL
Transaction of goods or services assumed to be the mutual consent about the agreement by the parties. TCT revolves around the expenses and the costs incurred before the transaction takes place in the business. And this theory got more importance when one brings it in the lending business like MFIs. Because, lending itself is a very risky business and that is why this needs to conduct quite a lot different kinds of verifications about the borrower. In case of group lending, this becomes more challenging to verify each and every detail or information
about the application given by different individuals before putting them in a
group. And this is not over, transaction cost also includes the cost of finding new
customers or borrowers, negotiating them and then monitoring them carefully so
that they would not feel any kind of discomfort. As I mentioned above that KBL
is only focusing on GBL approach and the biggest reason of doing this is that this
is how bank can touch many people in one time as they already in a need of
money in group. As per the theory, KBL is cutting its transaction cost down with
the help of sending its CSOs to the different regions where they visit a lot of
people in the rural areas within their own allotted sites. The bank is using the
services of the community organizations as well in order to verify the information
given by the borrowers to the CSOs with the application. Because of these
community organization, bank is not opening its new branches in the rural areas
as those areas have already been covered by the community organizations and in
rest of the areas bank sends its CSOs. KBL seems to be on target of saving the
money as much as they can so that they could save more fund to lend to the
poor. That is why, KBL is adopting the transaction cost theory with
determination.
Chapter 6

CONCLUSION

Micro financing is the idea which got highlighted in the last quarter of 20th century in order to make the world clear from the poverty and to create awareness among the people from all parts of the globe about the significance of good living standard as the majority of the world’s economies were struggling against the impacts and after facts of World War II. Because the only object which could be helpful at that time was the money and MFIs were introduced by the economists and the practitioners to take actions in this regards by lending the very poor part of the populations to help them out against the hunger and poverty. Because there was no single commercial bank who was willing to lend money to the poor without any collateral or security. So, it was a very daring step by the MFIs to start lending money initially with the personal guarantees and later on with the help of Group-Based Lending (GBL). Indeed, GBL has raised the repayment rates of MFIs but still MFIs are unable to be fully safe from the threat of non-repayment risk. As the purpose of my study was to analyze how the MFIs are managing their non-repayment rates and in order to fulfill it I conducted a study on a MFI (Khushhali Bank Limited, Pakistan). To manage the non-repayment risk by using GBL, it is very important to decide that how the MFI is going to formulate the groups of borrowers. My study indicates that the heterogeneity in the groups of borrowers can be less risky as compare to the groups of borrowers’ riskiness those are all homogeneous. The theories on which I judged my findings are stressing hard, especially in case of investment and lenders, which they do not need to invest in same kind of securities/borrowers if they are really want to get escape from the threats of non-repayment. While my subject MFI (KBL) is not concentrating on the diversification among the group
members. Unfortunately, what the KBL is doing in the name of diversification that is not risk diversification at all. They have just one condition in lending money which is that the people should know each other and must be resident of same locality. My research figures out on the basis of studying theories (discussed in Chapter 3) that this condition for giving loan is not enough to reduce or remove the risk of non-repayment. The study ends up in the favour of bringing diversification in the occupations of the groups of borrowers. The diversity among the occupation would lead the MFI on the much safer side. Here, I can take an example of group of farmers, if they made their group in order to get a loan from MFI, should the MFI allow them to make group with each other? If it is KBL they would allow but my study says that this would not be a sane decision by any MFI. While if the two or three different persons come to MFI with a different occupation that would be a good less risky group for lending because if the farmer fails to pay back then the other person who is not farmer can repay the liability on his behalf. As this is how they would help the MFI to save the motive of introducing GBL by joining the liabilities of the borrowers.

6.1. ANSWER TO RESEARCH QUESTION

*How is the group formation done in MFIs using Group-Based Lending approach to manage non-repayment risk?*

Lending to the people, those are not giving anything to the MFIs as a collateral or guarantee, was the biggest challenge faced by the MFIs. By keeping this challenge in minds, the GBL approach was introduced by the economists and practitioners to bring down the high probability of non-repayment risk. Controlling the non-repayment risk in micro financing has never been an unworthy task as the MFIs are never able to get anything as collateral from the borrower because their target market is the poor part of the population. This motive of evolution of GBL made the group formation is the most important and a sensitive function of the approach in a sense of managing non-repayment risk. Theories tell us that group
formation under GBL is not putting the individuals into the group of borrowers and held them responsible for joint liability and furthermore it is also not only about putting less risky persons into one group but it is about to take the less risky people with the diversification in their fields of businesses, in one group so that they can be fruitful in case any member defaults in his field of business. This is how the MFIs feel themselves way out of trouble in getting non-repayment risk. But after studying the theories in Theoretical framework, when I gathered the empirical data from of my subject MFI (KBL), I found that it is not doing the group formation accordingly. KBL is just giving the loans to the persons who come fits on their requirements and for the group formation, KBL got only one condition that the members of the group should be from same locality and must know each other. So, KBL is even not merely way out of the motive of group formation but also the have no idea of bringing risk diversification in the formation of the group. Once KBL will adopt the risk diversification in the formation then it can take the benefits of it by managing non-repayment risk under GBL because otherwise, KBL is just not taking the advantage of using GBL and doing no favour to its loan schemes by ignoring the significance of risk diversification among the members of the group of borrowers’ while conducting the group formation.

6.2. IMPLICATIONS

On the basis of my limited study, I feel that the following steps would be helpful for the MFIs.

6.2.1. Well - Defined Policies

MFIs should lay down clear cut, well defined and written managerial policies so that employees and manager should be aware of the rules and
standards to be adopted. Moreover, these policies should be communicated to the employees of all levels.

6.2.2. Diversified Portfolio

MFIs need to advance loans to various different sectors of the economy instead of concentrating on very small enterprises especially individual persons without any discrimination of gender. But they need to do diversification, which is used by the MFIs as keeping the borrowers’ occupations in the mind when they plan to formulate groups among them. This would result in better returns to the Bank as slump in one sector would not hinder the recovery of funds. Credit policies in this regard should be very definite.

6.2.3. Feedback from the customers

Feedback from the customers should be taken on regular basis on the products that are presently offered. Suggestions for improvement should also be asked for. Bank should ask its valued customers to apprise them of any problem they face, listen to their complaints and should have a positive attitude towards the customer feedback.

6.2.4. Interaction

MFIS managers should have strong and healthy interaction with the groups of borrowers. They should have a friendly attitude to them in order to increase their productivity.
6.2.5. Cost Controlling

MFIs should try to minimize the cost of obtaining funds and should utilize the funds maximally. Moreover the Bank should try to control general and administrative expenses as they are increasing year by year.

6.3. LIMITATIONS

Needless to say, there have been quite lot limitations during conducting my study. Due to time constraint and having less span of time for this research, I could not take into consideration more than one case study. It was very difficult to gather primary data from my subject MFI (KBL) which is operating its activities in Pakistan while I am conducting my research here in Sweden. The only thing I could do, in this regards is to make telephonic conversation with the authorities or the concern personnel in bank. I could not use the other methods of data collection due to distance from the location as well as time limitation like Consumer survey through questionnaire, Market analysis, Survey with work force and comparison two MFI's. I also wanted to conduct more interviews in this regard to get a look over the performance of the Institution but due to their busy schedules could not access them again. This is quite tough to make a continuous contact not only from the KBL’s senior management, directors or CEO but of any big institution in the globe because of their busy schedules especially, when the interviewers and the interviewees are miles away. I just conducted the detailed telephonic interview of two persons. One more limitation is that I could not gather any statistical data to reflect the past and current situations of the non-repayment risks and recoveries as I feel that those figures can make reader very comfortable in understanding the matter. According to my limited study and observation, I tried my level best to present quality research by valid and reliable data.
6.4. SUGGESTIONS FOR FURTHER RESEARCH

After having the experience of researching in the micro financing sector, I am able to say that there is still more different market surveys and analysis are required to get deeper understanding and analysis of problem in more efficient and effective manners. Although I tried to work hard to prove my thesis, but as I worked on a focused area so there are still plenty of areas in this section of work on. This research study was conducted to learn and articulate the ongoing management of non-risk payment by adopting GBL and the formation of groups with the theories in literature. My intention was only to assess whether the theories have any significance when practiced in real. The results are hopeful and provided a platform to widen the scope of study in microfinance sector and see how measures to improve the probability of non-repayment risk can be achieved. I was time, geographic and resource bounded which leaves enough room to find out what related practices exist in other sectors of the corporate world. This study can be extended to detailed comparison between homogeneity and heterogeneity among the members of the groups of borrowers in order to analyze the impact of them on not merely the non-repayment risk but also on other operating risks. This would lead to a better glimpse of the scenario which would be a more thorough and rigorous representation of this research study. I am optimistic that the theories I learnt in literature have a broad and wider implementation capability in reaching the purpose of the study.
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APPENDIX

INTERVIEW RELEASE FORM

Project name: Managing Non-Repayment Risk through Group-Based Lending in MFIs (The case study of Khushhali Bank Limited, Pakistan)

Date: May 25 & 28, 2009

Interviewer: Muhammad SALMAN Qureshi

Name of Persons Interviewed:

Mr. Anwar Shakeel	Mr. Zahid Rafique
Branch Manager	Credit Control Manager

Company: Khushhali Bank Limited, Pakistan
QUESTIONS

General
1. Total number of employees?
2. In which part of the country bank is more focusing rural or urban?
3. Are you focusing male or female in disbursement or both?
4. How does the bank make assessment of a genuine borrower?
   i. Does the bank use the services of local authorities to reach the poor in rural areas?
   ii. Does the bank make any verification of borrowers when they come for loan? If YES then how it does (either you use the services of any local authorities or NADRA or verification from The Central Bank)?
5. Group-Based Lending (GBL) is the only approach used by the bank for lending?
   i. Why does the bank use GBL in the existence of individual or traditional lending?
   ii. What are the advantages & disadvantages of GBL while using it?
   iii. What are the benefits of GBL that bank is gaining?
   iv. What are the affects of GBL in comparison of individual lending to the poor or borrowers?
   v. Is the interest rate same in GBL or not in comparison with traditional lending?
6. Group Formation is being done by the bank or by the borrowers themselves?
   i. What are the criteria (rules of making a group) used by the bank in formulating a group of borrowers?
   ii. Are there any circumstances when bank allow borrowers to formulate their own group?
   iii. Does the bank have any condition of diversified occupations among the members of the group?
   iv. Does bank monitor the working of the group? If YES then how does the bank do it so?
   v. Does the bank re-formulate the group and why? If YES then what are those circumstances?
7. How much the monitor cost does affect the transaction cost?
   i. Whether the group members monitor each others’ activities or not? If YES then how?

8. What if the bank does not get the loan money back from the group?
   i. What does the GBL contract say about the responsibility of loan payment in case of default of one or two members in a group?